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# In the Supreme Court of the United States

OCTOBER TERM, 1958

No. 663

MONROE ZIPP, et al.,

*Petitioners,*

v.

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

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## PETITION FOR WRIT OF CERTIORARI
To the United States Court of Appeals
For the Sixth Circuit.

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## TABLE OF CONTENTS.


Opinions Below ..... 1

Jurisdiction ..... 2

Statutes Involved ..... 2

Question Presented ..... 3

Statement ..... 4

Reasons for Granting the Writ ..... 6

I. The Court of Appeals' decision that Petitioners received taxable income in the year 1950 is in conflict with decisions of this Honorable Court defining "Income" for tax purposes under the Sixteenth Amendment to the Constitution of the United States ..... 6

II. The Court of Appeals for the Sixth Circuit has rendered a decision in the instant case which is in conflict with decisions of other Courts of Appeal on the same matter ..... 8

III. The Court of Appeals' novel holding below has decided an important question of federal tax law which has not been, but should be settled by this Honorable Court ..... 10

Conclusion ..... 15

Appendix:

Opinion of the United States Court of Appeals for the Sixth Circuit ..... 16

Judgment of the United States Court of Appeals for the Sixth Circuit ..... 19

Order Denying Rehearing ..... 19

## TABLE OF AUTHORITIES

### Cases.


*Edenfield, Ray* (1952), 19 T. C. 18 ..... 8

*Eisner v. Macomber* (1920), 252 U. S. 189 ..... 7, 8

*Ferro v. Commissioner* (C. A. 3rd, 1957), 242 F. 2d 838 ..... 6

*Fischer, Fred F.* (1947), 6 T. C. M. 520 ..... 8

*Fox v. Harrison* (C. C. A. 7th, 1944), 145 F. 2d 521 ..... 8

*General Utilities & Operating Co. v. Helvering* (1935), 296 U. S. 200 ..... 8

*Hatcher, J. S.* (1930), 18 B. T. A. 632 ..... 8

*Helvering v. San Joaquin Fruit & Investment Co.* (1936), 297 U. S. 496 ..... 8

*Holsey v. Commissioner* (C. A. 3rd, 1958), 258 F. 2d 865, rev'g. 28 T. C. 962 (1957) ..... 7-8, 9

*LaBelle Iron Works v. U. S.* (1921), 256 U. S. 377 ..... 8

*Lowenthal v. Commissioner* (C. A. 7th, 1948), 169 F. 2d 694 ..... 6

*Lowrence, A. M.* (1928), 13 B. T. A. 463 ..... 8

*Lynch v. Turrish* (1918), 247 U. S. 221 ..... 8

*Schmidt v. Commissioner* (C. A. 3rd, 1954), 208 F. 2d 819, rev'g. 20 T. C. 352 ..... 8

*S. M. K. Ames, Inc.* (1942), 46 B. T. A. 1020, acq. 1942-1 C. B. 1 ..... 8

*Tucker v. Commissioner* (C. A. 8th, 1955), 226 F. 2d 177, rev'g. 23 T. C. 115 (1954) ..... 8, 10

*Wall v. United States* (C. C. A. 4th, 1947), 164 F. 2d 462 ..... 6

*Woodworth v. Commissioner* (C. A. 6th, 1955), 218 F. 2d 719 ..... 6

*Youell, George* (1929), 18 B. T. A. 599 ..... 8

**Constitution.**

Constitution of the United States, Sixteenth Amendment ..... 6

**Statutes.**

Internal Revenue Code of 1939:

Sec. 115(a) ..... 2, 5, 6, 7

Sec. 115(g) ..... 3

Sec. 275(c) ..... 3

Internal Revenue Code of 1954, Secs. 7482 and 7483 6

28 U. S. C. 1254(1) ..... 2

**Miscellaneous.**

Graham, *Redemption Problems*—The *Holsey* and *Zipp* cases, 36 Taxes 925 (Dec. 1958) ..... 14

Hobbet, *The New Attack on Stock Redemptions*, 35 Taxes 830 (Nov. 1957) ..... 14

Jones, *How Stock Redemptions Produce Dividend Income*, 36 Taxes 437 (June 1958) ..... 14

*Journal of Taxation*, May, 1958, page 306 ..... 12

1 *Mertens Law of Federal Taxation*, secs. 5.04, 5.05 .. 8

Rev. Rul. 58-614, 1958-51 IRB 49 ..... 9

Rubin, *Another Hazard in Redemption of Corporate Stock*, 44 Amer. Bar Assn. J. 177 (Feb. 1958) .. 14

Seidman, *The Unexpected, Untimely and Uninvited Dividend*, 36 Taxes 166 (Mar. 1958) ..... 14

Strecker, *Corporate Buy-Sell Agreements: Tax Problems*, 15 Wash. & Lee L. Rev. 18, 23 (Sp. 1958) 14

Surrey and Warren, *Federal Taxation—Current Law Practice*, par. 1215, p. 371 (Dec. 1957) ..... 12

Tomlins, *Dividend from Stock Redemption of Third Party*, 11 Okla. L. Rev. 99 (Fall 58) ..... 14

# In the Supreme Court of the United States

**OCTOBER TERM, 1958.**

**No. /----------.**

MONROE ZIPP, *et al.*,

*Petitioners,*

v.

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

## PETITION FOR WRIT OF CERTIORARI
## To the United States Court of Appeals
## For the Sixth Circuit.

*To the Honorable Chief Justice and the Associate Justices of the Supreme Court of the United States.*

Monroe Zipp and Helen Zipp, Bernard Zipp and Jean B. Zipp, your Petitioners, pray that a Writ of Certiorari issue to review the judgments of the United States Court of Appeals for the Sixth Circuit, entered in the above entitled cases on May 21, 1958, affirming decisions of the Tax Court of the United States against your Petitioners.

## OPINIONS BELOW.

The cases herein presented were consolidated for trial in the Tax Court of the United States, which rendered decisions against your Petitioners on July 10, 1957 and are reported at 28 T. C. 314. The opinion of the Tax Court appears at page 107a of Petitioners' Appendix Rec-

ord below, nine extra copies of which are filed herewith. A petition for review was timely filed in the United States Court of Appeals for the Sixth Circuit and judgment rendered affirming the decisions of the Tax Court. The Court of Appeals opinion, rendered per curiam, is reported at 259 F. 2d 119 (Appendix page 16, *infra*).

## JURISDICTION.

The judgment of the United States Court of Appeals for the Sixth Circuit was rendered on May 21, 1958. A petition for rehearing was timely filed by your Petitioners and was denied by said Court of Appeals on October 27, 1958.

The statutory provision conferring jurisdiction upon this Honorable Court to review the judgment against your Petitioners by said Court of Appeals is Sec. 1254(1) of Title 28, United States Code.

## STATUTES INVOLVED.

Pertinent sections of statutes involved herein and in force at the times involved are as follows:

Internal Revenue Code of 1939:

"Sec. 115(a). *Definition of Dividend*—The term 'dividend' when used in this chapter (except in section 201(c)(5), section 204(c)(11) and section 207(a)(2) and (b)(3) (where the reference is to dividends of insurance companies paid to policy holders)) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable

year), without regard to the amount of the earnings and profits at the time the distribution was made. * * *"

"Sec. 115(g) *Redemption of Stock*

(1) In General—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend."

"Sec. 275(c) *Omission from Gross Income*—If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 per centum of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 5 years after the return was filed."

## QUESTION PRESENTED.

Where a portion of the stock of a shareholder in a closely held corporation is purchased by the corporation, the remainder of the stock held by said shareholder then being transferred to the remaining shareholders, who are under no obligation to purchase or pay for such stock, and which transactions result in the remaining shareholders becoming the sole shareholders of such corporation, does the payment to the selling shareholder by the corporation for such stock out of its earnings and profits result in a distribution essentially equivalent to a taxable dividend to the remaining shareholders?

## STATEMENT.

Paramount Steel and Supply Co. (hereinafter referred to as Paramount) was an Ohio corporation organized on August 29, 1936 and had its principal place of business and offices, plant and yard at Cleveland, Ohio. Paramount's business at all times was the purchase, processing and resale of scrap iron. Louis Zipp (hereinafter sometimes referred to as Louis), the father of Monroe and Bernard Zipp (hereinafter called Monroe and Bernard, Petitioners, or sons), organized Paramount with authorized stock of 100 shares of no par value common stock, of which 50 shares were issued with a declared value of $10.00 per share. As of May 23, 1947 Louis held 48 shares and Bernard and Monroe each held one share.

Bernard and Monroe worked for Paramount in various capacities. On May 24, 1947 Louis transferred 23 shares of Paramount stock to each of his sons. Pursuant to this transfer Louis filed a Federal gift tax return reporting the gift of the 46 shares to his sons and paid the gift tax.

Subsequently there were arguments between Louis and his sons over the policies and operations of Paramount and in May of 1950 they became involved in a serious dispute. It was then decided that Louis would leave the business, and his interest in Paramount would be terminated completely. On May 29, 1950 an agreement was executed between Louis and Paramount which provided in substance as follows:

(1) Louis agreed to sell his two shares of Paramount stock to Paramount, to resign as director and general manager of Paramount, to relinquish all claim to and right in any further salaries and extra compensation from Paramount in 1950 and thereafter, and not to engage in

the business of buying, selling or dealing in scrap metals or in any other similar business in Ohio for a period of ten years nor to interfere in any manner with the business of Paramount in Ohio.

(2) In consideration of the foregoing Paramount agreed to pay Louis $75,000 in cash, to forgive all sums owing to Paramount by Louis, and to convey to him a Cadillac automobile. The consideration passing to Louis from Paramount totaled $93,782.50. At the time this agreement was executed the earned surplus of Paramount amounted to $93,790.90, and this surplus represented earnings of the corporation since its organization in 1936.

The Commissioner contended that Paramount's payment of $93,782.50 to Louis constituted taxable dividends to the sons under Sec. 115, Internal Revenue Code of 1939. The Tax Court found that the transfers of stock to Petitioners in 1947, notwithstanding the filing of gift tax returns, were not gifts but rather transfers of title with retention of beneficial interest in Louis. The court further found that, in connection with the sale of the two shares by Louis to Paramount, Louis released to the Petitioners all of his interest in the said 46 shares held by Petitioners.

**The Court did not find any agreement between Louis and the Petitioners relating to this transfer to them, nor did it find that the Petitioners in any way obligated themselves personally to pay for any part of the stock sold by Louis.**

**The only existing obligation to pay for the shares purchased was the corporation's.**

On July 10, 1957 the Tax Court nevertheless rendered decisions sustaining the deficiencies of $20,926.88 asserted against each son.

A petition for review of the Petitioners' cases was timely filed in the Court of Appeals for the Sixth Circuit pursuant to Secs. 7482 and 7483 of the Internal Revenue Code of 1954. In a *Per Curiam* opinion rendered on May 21, 1958 the Court of Appeals affirmed the decisions of the Tax Court in both cases. Petitioners filed a petition fer rehearing which was denied by the Court of Appeals on October 27, 1958.

## REASONS FOR GRANTING THE WRIT.

**I. The Court of Appeals' decision that Petitioners received taxable income in the year 1950 is in conflict with decisions of this Honorable Court defining "Income" for tax purposes under the Sixteenth Amendment to the Constitution of the United States.**

In order for the Petitioners to be charged with the receipt of a taxable dividend, it must be shown either:

(1) that *Petitioners* received a distribution from the corporation of money or property out of the corporation's accumulated earnings and profits. Sec. 115(a), Internal Revenue Code of 1939; or

(2) that a distribution by the corporation to a third party was a constructive dividend to Petitioners in that it discharged some obligation or indebtedness of the Petitioners. *Ferro v. Commissioner* (C. A. 3rd, 1957) 242 F. 2d 838; *Woodworth v. Commissioner* (C. A. 6th, 1955) 218 F. 2d 719; *Lowenthal v. Commissioner* (C. A. 7th, 1948) 169 F. 2d 694; *Wall v. United States* (C. C. A. 4th, 1947) 164 F. 2d 462.

Admittedly no distribution was made directly to the Petitioners. All moneys and property were paid by Paramount to Louis. Therefore, the first requirement above has not been shown.

Neither has it been found that any obligation or indebtedness of the Petitioners existed in connection with the purchase of Louis' stock by Paramount. They neither agreed to buy nor to pay for any part of Louis' shares. The second requirement as to taxability therefore also fails.

It would appear, consequently, that the *only* bases upon which the Commissioner's contention and the courts' decisions can be grounded are that (1) the release by Louis to the Petitioners of his beneficial interest in the 46 shares was a constructive dividend to the Petitioners; or (2) the increase in Petitioners' percentage ownership of the corporation by the redemption of Louis' interest resulted in a constructive dividend to Petitioners. Both of these contentions must fall.

(1) First, the release by Louis can in no wise be construed to be a distribution *by the corporation*. Sec. 115, 1939 Code. Second, had Louis not released the shares to Petitioners but rather to the corporation, the Petitioners would then have owned two shares of stock, being all of the then outstanding shares. By receiving the 46 shares, the Petitioners owned 48 shares, being all of the then outstanding shares. It is obvious, therefore, that all that was accomplished by the release of the 46 shares to the Petitioners was that they owned more shares but no greater interest in the corporation.

This court has held in *Eisner v. Macomber* (1920) 252 U. S. 189 that a stock dividend distributed to stockholders which merely increased the number of shares held, but not the proportionate ownership of the corporation, was not a taxable dividend.

(2) The mere increase in the proportionate ownership of the corporation which results from the redemption of all of a shareholder's stock has been held not to be a taxable dividend to the remaining stockholders. *Holsey*

*v. Commissioner* (C. A. 3rd, 1958) 258 F. 2d 865, rev'g. 28 T. C. 962 (1957); *Tucker v. Commissioner* (C. A. 8th, 1955) 226 F. 2d 177, rev'g. 23 T. C. 115 (1954); *Joseph P. Schmidt v. Commissioner* (C. A. 3rd, 1954) 208 F. 2d 819, rev'g. 20 T. C. 352; *Fox v. Harrison* (C. C. A. 7th, 1944) 145 F. 2d 521; *Ray Edenfield* (1952) 19 T. C. 13; *Fred F. Fischer* (1947) 6 T. C. M. 520; *S. M. K. Ames, Inc.* (1942) 46 B. T. A. 1020, acq. 1942-1 C. B. 1; *J. S. Hatcher* (1930) 18 B. T. A. 632; *George Yowell* (1929) 18 B. T. A. 599; *A. M. Lowrence* (1928) 13 B. T. A. 463.

In some of the cases cited the redemption resulted in substantial increase in value of the remaining shareholders' stock; yet no taxable dividend was found. See also the following decisions of this Court for the proposition that a mere increase in the value of property is not income, but merely an unrealized increase in capital. *Helvering v. San Joaquin Fruit & Investment Co.* (1936) 297 U. S. 496; *General Utilities & Operating Co. v. Helvering* (1935) 296 U. S. 200; *LaBelle Iron Works v. U. S.* (1921) 256 U. S. 377; *Eisner v. Macomber, supra; Lynch v. Turrish* (1918) 247 U. S. 221; see also, 1 Mertens *Law of Federal Taxation,* secs. 5.04, 5.05. *A fortiori,* this rule should apply where, as here, the redemption of Louis' stock actually resulted in a decrease in value of the Petitioners' shares.

**II. The Court of Appeals for the Sixth Circuit has rendered a decision in the instant case which is in conflict with decisions of other Courts of Appeal on the same matter.**

In *Holsey v. Commissioner* (C. A. 3rd, 1958) 258 F. 2d 865, rev'g. 28 T. C. 962 (1957), the taxpayer was a 50% stockholder in a corporation. The other 50% stockholder granted to the taxpayer the option to purchase all

of his shares for a certain price. Prior to the exercise of the option and when the stock of the optionor had increased greatly in value, the taxpayer transferred the option to the corporation, the corporation exercised the option and purchased the shares at the low option price. Taxpayer thus became the holder of all of the outstanding stock of the corporation.

The Tax Court held that the purchase of the stock by the corporation resulted in a taxable dividend to *Holsey*, the remaining stockholder, on the theory that the purchase of the stock by the corporation was for *Holsey's* "benefit."

The Court of Appeals for the Third Circuit reversed the Tax Court, holding that the redemption was not "essentially equivalent to a dividend." It stated that to be taxable the distribution must be made *to* a taxpayer or *for* his benefit. The fact that the taxpayer's own stock increased in value or that his proportionate interest in the corporation was thereby increased does not justify taxation of these *indirect* benefits as dividends.

It is submitted that the decision of the Court of Appeals for the Sixth Circuit in the instant case is in direct conflict with *Holsey, supra.*

In both cases the distribution was made to persons other than the taxpayer, the percentage of ownership of each was thereby increased, neither had a personal obligation to purchase the shares of the retiring shareholder or to pay for them, and the indirect benefits obtained by each taxpayer were identical in nature.

The Commissioner of Internal Revenue has acquiesced in the *Holsey* case. See Rev. Rul. 58-614, 1958-51 IRB 49, stating that "In the future, the Service will not treat the purchase by a corporation of one shareholder's stock as a dividend to the remaining shareholders merely

because their percentage interests in the corporation are increased."

The decision of the Circuit Court in this case is also in direct conflict with *Tucker v. Commissioner* (C. A. 8th, 1955) 226 F. 2d 177, rev'g. 23 T. C. 115 (1954), where the taxpayer *personally* agreed to purchase the shares of another stockholder, the corporation agreeing to pay to the seller part of the purchase price of the stock in the form of a percentage of profits.

The Tax Court held that such payments by the corporation were constructive dividends to the taxpayer. The Court of Appeals for the Eighth Circuit reversed the Tax Court decision, notwithstanding the satisfaction of the taxpayer's *personal obligation* by the corporate payments.

**III. The Court of Appeals' novel holding below has decided an important question of federal tax law which has not been, but should be settled by this Honorable Court.**

It has long been recognized that a market place for capital investments is an essential element of our economic system. Such a market place is the stock market where investors are reasonably able to liquidate investments or change from one to another. The stock market contributes greatly to the confidence in the economy as a whole and it attracts capital out of savings accounts to be put to more productive uses which benefit the nation's economy. Stock exchanges efficiently perform this important service for investors in corporations large enough to list their securities in the exchanges. Over-the-counter markets also provide this service for other securities which are sufficiently widely held to allow rather steady sale and purchase ac-

tivity. Investors in these securities are able to buy and sell and receive the benefit of capital gains rates on any gains if the investment is held for the minimum six-month period.

Everyone will agree that small business is an important part of our economy and that it is worth preserving as well as promoting. Congress recognizes this as shown by the favorable Small Business legislation enacted into law in 1958 and also is shown by the provisions of the Internal Revenue Code of 1954 which favor small businesses. Investment in new and small corporate enterprises is necessary if opportunities for profits for individual investors are to be preserved, as distinguished from institutional and corporate investors. However, there is no comparable market place for investments in closely held corporations where such investments may be easily exchanged for reasonably adequate consideration. Few investors are willing to buy a part of a small business and only where there is mutual trust and confidence between such investors do they join together in a joint enterprise.

When an investor in a small corporate business for any of a multitude of reasons chooses to liquidate his investment, fairness demands that he be as free to do so as other taxpayers. When it comes to liquidating such investments, generally only the corporation itself can serve the function of the market place and provide funds to liquidate the investment at a reasonable price. The use of the corporation as such a market place seems proper since the investment was put into the corporate enterprise by the investor and, if successful, profits were earned thereon and taxed.

However, because of the holding of the Tax Court and Court of Appeals in the case at bar, the liquidation of the investment of a risk-taker in a closely held corpora-

tion would result in the Commissioner receiving two taxes on the distribution by the corporation in liquidation of the retiring investor's interest, i.e., a capital gain or ordinary income tax on the gain to the retiring investor and an ordinary income tax in the amount of the distribution to the remaining investors. This result certainly does not provide the type of climate which would encourage and promote individual risk-takers to invest capital in new and small corporate businesses. Furthermore Congress did not intend such a result. As stated by Prof. Surrey and Dean Warren:

> "Is the result of a dividend (to the surviving shareholder) intended by a Congress which went to extreme pains in Sec. 302(b)(3) (of the Internal Revenue Code of 1954) to make sure that the redemption would not fail of accomplishment because of the fear of a dividend (to the deceased or retiring shareholder). But the dividend result for (the surviving shareholder) would equally block the redemption." C. C. H. Surrey and Warren, *Federal Taxation—Current Law Practice*, par. 1215, p. 371 (Dec. 1957).

In the Committee reports of the Select Committee on Small Business of the United States Senate (86th Congress) reported in the *Journal of Taxation*, May, 1958, at page 306, the following statement was made condemning the Tax Court opinion in the instant cases as thwarting the intent of Congress:

> "Another example of administrative discrimination toward small concerns is exemplified by a statement submitted at the Minneapolis hearing:
>
> > 'I am particularly concerned by an apparent *new concept* in taxing stock redemption by small-business corporations and which, if broadly enforced, will result in great tax inequity and an impossible tax burden on small corporations.'

"The witness went on to explain that the treasury was arguing that a redemption of stock of another stockholder was a dividend to him.

'This concept, I am told, is supported by two recent cases of the Tax Court of the United States (*Joseph R. Holsey*, 28 T. C. No. 107, August, 1957, and *Louis H. Zipp*, 28 T. C. No. 32, May, 1957). This redemption has not increased my present net worth in any sense and the "constructive dividend" so called is non-existent.

'To my way of thinking, this new concept cannot help but result in killing off any incentive to let small corporations grow. Shareholders, who are also employees, will want to withdraw earnings in the form of salaries rather than to expand their business, realizing that any expansion will result in a greater tax to them when any shareholder died or wants to withdraw.' * * *

*"The Treasury in each of these examples has set out to accomplish something not provided for by law and in the last two instances (referring to the Zipp situation) actually appears to run counter to the intent of Congress* * * *

"In the first instance, your Committee wishes to condemn any activity which operates to negate a benefit intended by Congress. In instances cited in the above discussions, it is clear that Treasury has dragged its feet and operated to thwart the intent of Congress where provisions did not meet with Treasury approval. * * *" (Emphasis ours.)

The importance and unsoundness of the Tax Court and Court of Appeals decisions in the administration of the Federal tax law as applied to closely held corporations is illustrated by the unusually numerous authoritative articles uniformly criticizing these decisions published in recent periodicals. Robert F. Graham, *Redemption Prob-*

*lems*—The *Holsey* and *Zipp* cases, 36 Taxes 925 (Dec. 1958); Prof. Richard Lloyd Strecker, *Corporate Buy-Sell Agreements: Tax Problems,* 15 Wash. & Lee L. Rev. 18, 23 (Sp. 1958); Harry Lamar Jones, *How Stock Redemptions Produce Dividend Income,* 36 Taxes 437 (June 1958); L. William Seidman, *The Unexpected, Untimely and Uninvited Dividend,* 36 Taxes 166 (Mar. 1958); C. D. Tomlins, *Dividend from Stock Redemption of Third Party,* 11 Okla. L. Rev. 99 (Fall 58); Alvin B. Rubin, *Another Hazard in Redemption of Corporate Stock,* 44 Amer. Bar Assn. J. 177 (Feb. 1958); Richard D. Hobbet, *The New Attack on Stock Redemptions,* 35 Taxes 830 (Nov. 1957).

The importance of the decisions of the Tax Court and Court of Appeals here is obviously recognized when one considers the frequent use of "buy and sell" agreements and other stock sale restrictive agreements to insure corporate harmony and control in closely held corporations. Taxpayers and their representatives and the tax bar as a whole are shocked by the decisions here and are in a quandary as to how redemptions or purchases under these agreements that have existed for years will be treated by the Commissioner and the courts. Furthermore, the use of such agreements in the future is shrouded with doubt and taxpayers' representatives are unable to advise how a retiring or deceased stockholder's interest in a closely held corporation may be liquidated without disastrous consequences to the remaining stockholders in the form of receipt of constructive dividends taxed at ordinary income rates.

Petitioners submit that the decisions of the Tax Court and Court of Appeals in the instant case announce for the first time the principle that where a closely held corporation redeems or purchases all the stock of a retiring or

deceased stockholder, the remaining stockholders have received constructive dividends in the form of the increase in their proportionate interest and control, and the "benefit received" thereby is valued by the amount of the distribution. Petitioners believe the instant case to be the only case which still stands for this result and submit that this Honorable Court has never before decided the issue presented here.

## CONCLUSION.

For the reasons set forth above, and because of the conflict in decisions of various Circuits of the United States Court of Appeals, and the far-reaching consequences of the decision of the United States Court of Appeals for the Sixth Circuit, it is respectfully submitted that this petition for a Writ of Certiorari should be granted.

Respectfully submitted,

FRED H. MANDEL,
*Counsel for Petitioners.*

# APPENDIX.

## OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT.

(Nos. 13374-75.)

(Decided May 21, 1958.)

Before SIMONS, Chief Judge; MARTIN, Circuit Judge; and JONES, District Judge.

PER CURIAM. The petitions of two brothers, Monroe Zipp and Bernard Zipp, and their respective wives for review of decisions of the Tax Court of the United States, holding deficiencies of $20,926.88 in the income taxes of each for the year 1950, were consolidated for hearing. The somewhat complicated transactions between the two brothers and their father, Louis Zipp, the founder and practically sole owner of the Paramount Steel and Supply Company, led to this tax litigation.

The Paramount Steel and Supply Company had a total of fifty outstanding shares of capital stock: all of which, except a few qualifying shares, were owned by Louis Zipp. On May 24, 1947, he caused to be transferred to his two sons, Bernard and Monroe, 23 shares each of the capital stock of the company. The certificates were endorsed by the sons in blank and delivered to the custody of their father's attorney, who was also attorney for Paramount.

As found by the Tax Court, Louis Zipp, the father, in contemplation of a re-marriage consummated in 1947, discussed with his attorney the possible effects of such step upon his financial interest in Paramount and the possibility of future marital difficulties, which might jeopardize his interest in the company as well as interfere with the operation of its business. The Tax Court found on substantial evidence that, on advice of the at-

torney, all shares, except two, of the Paramount stock owned by Louis Zipp were put in the names of his two sons "so that they could not be reached by Louis' wife, if marital difficulties arose, or in the event of Louis' death, or in the event Louis became involved in any financial deals."

On May 29, 1950, the father—after he had been in a controversy with his sons—entered in an agreement in writing whereby he acknowledged that he had no interest, right, title or claim whatever in the two certificates for 23 shares each, issued to his respective sons, Bernard and Monroe Zipp. In accordance with the terms of the agreement, Louis Zipp received from the Paramount company the total consideration of $93,782.50, comprising $75,000 in cash, cancellation of an indebtedness to the company of $16,682.50, and an automobile valued at $2,100. The agreement recited that the earned surplus of Paramount as of May 29, 1950, amounted to $93,790.90.

The total consideration received by the father from Paramount was in exchange for all his forty-eight shares of stock in the company, whereof only two shares stood in his name. The certificates for these two shares were endorsed by him in blank and surrendered to the company. The result of the transaction was that, after May 29, 1950, the two Zipp brothers owned all the fifty shares of outstanding stock in Paramount Steel and Supply Company. Funds of the company were used to purchase this stock in an equal number of shares for each brother. The brothers did not report any income from the transaction of May 29, 1950.

The Commissioner of Internal Revenue determined that the deficiency in income tax liability of each of the petitioners, Monroe and Bernard Zipp, amounted to

$46,891.25, or one-half of $93,782.50, inasmuch as that amount had been withdrawn from the Paramount company by Louis H. Zipp in payment for forty-six shares of the company's capital stock which were acquired by the sons from their father as a result of the transaction. The Commissioner concluded from this that fifty percent of $46,891.25 was taxable as dividends to each of the brothers. The Tax Court upheld this determination by the Commissioner upon the ground that the father, Louis Zipp, had not made completed bona fide gifts of twenty-three shares of stock to each of his sons in May of 1947; that his sons had been made mere nominees whose names were used to suit his convenience; and that Louis Zipp had remained owner of the shares and was such at the time he entered into the agreement with Paramount on May 29, 1950.

The Tax Court concluded that Paramount had paid Louis Zipp $93,782.50 for all forty-eight shares of his stock and that Louis Zipp had sold these shares, it being abundantly clear that the transactions of May 29, 1950, were to enable the sons to purchase all the father's interest in the Paramount Steel and Supply Company; and that, it being a family corporation, it was possible for them to proceed as they had. It was reasoned further that the sons had not made loans from Paramount, but had caused its cash to be distributed for their benefit, namely, to enable them to purchase all their father's stock. It was reasoned further that, inasmuch as Paramount had accumulated earned surplus in the amount of $93,790.90, it must be concluded that the payment of $93,782.50 by Paramount constituted taxable dividends constructively received in equal parts by the two sons. See I. R. C., 1939, § 115(b); cf. *Paramount-Richards*

*Theatres v. Commissioner*, 53 F. (2d) 602, 604 (C. A. 5); *Byers v. Commissioner*, 199 F. (2d) 273, 275 (C. A. 8).

Accordingly, for the foregoing reasons, more fully disclosed by the findings of fact and the opinion of the Tax Court, the decision of that court in each of these two cases is affirmed.

**JUDGMENT OF THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT.**

(No. 13,374.)
(Filed May 21, 1958.)

On petition to review a decision of the Tax Court of the United States.

This cause came on to be heard on the transcript of record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is now here ordered and adjudged by this court that the decision of the said Tax Court in this cause be and the same is hereby affirmed.

(A like judgment was entered in Case No. 13,375.)

**ORDER DENYING REHEARING.**

(Nos. 13,374 and 13,375.)
(Filed October 27, 1958.)

The petition for rehearing is denied.

## COUNTER-STATEMENT OF QUESTION INVOLVED

1. Whether the payment of the sum of $93,782.70 by a corporation to its (retiring) principal stockholder in exchange for all his stock was paid on behalf of the taxpayers (the new sole stockholders) and therefore resulted in the constructive receipt of dividends by them.

The Tax Court answered the question "Yes."

The Commissioner contends it was properly answered "Yes."

2. Whether the assessment and collection of the deficiency due from each taxpayer for the taxable year 1950 is barred by the statute of limitations.

The Tax Court answered the question "No."

The Commissioner contends that it was properly answered "No."

# INDEX


Page

Counter-statement of questions involved ..... I

Index ..... II

Counter-statement of facts ..... 1

Argument:

I. Whether the payment of the sum of $93,782.70 by a corporation to its (retiring) principal stockholder in exchange for all his stock was paid on behalf of the taxpayers (the new sole stockholders) and therefore resulted in the constructive receipt of dividends by them ..... 7
The Tax Court answered the question "Yes"; the Commissioner contends that it was properly answered "Yes" ..... 7

A. There was no valid gift ..... 7

B. Paramount paid Louis Zipp $93,782.50 for his 48 shares of stock, and the miscellaneous covenants were merely incidental to the disposition of the stock ..... 12

C. The transaction resulted in the constructive receipt of dividends by taxpayers in 1950 ..... 15

II. Whether the assessment and collection of the deficiency due from each taxpayer for the taxable year 1950 is barred by the statute of limitations ..... 23
The Tax Court answered the question "No"; the Commissioner contends that it was properly answered "No" 23

Appendix A ..... 25

Appendix B:

Joint Exhibit 7-G ..... 1b

Petitioners' Exhibit 10 ..... 9b

## CITATIONS

CASES: Page

*Boehm* v. *Commissioner*, 326 U.S. 287 ..... 10
*Bogardus* v. *Commissioner*, 302 U.S. 34 ..... 13
*Chattanooga Sav. Bank* v. *Brewer*, 17 F. 2d 79, certiorari denied, 274 U.S. 751 ..... 22
*Christopher* v. *Burnet*, 55 F. 2d 527 ..... 22
*Cohen* v. *Commissioner*, 77 F. 2d 184, certiorari denied, 296 U.S. 610 ..... 22
*Commissioner* v. *Court Holding Co.*, 324 U.S. 331 ..... 10
*Commissioner* v. *Sullivan*, 210 F. 2d 607 ..... 16, 19
*Curtis Co.* v. *Commissioner*, 232 F. 2d 167 ..... 9
*Douglas* v. *Wallcuts*, 296 U.S. 1 ..... 21
*Earle* v. *Woodlaw*, 245 F. 2d 119 ..... 16
*Elmhurst Cemetery Co.* v. *Commissioner*, 300 U.S. 37 ..... 9
*Ferro* v. *Commissioner*, 242 F. 2d 838 ..... 16, 19
*Flanagan* v. *Helvering*, 116 F. 2d 937 ..... 16
*Fox* v. *Harrison*, 145 F. 2d 521 ..... 16, 22
*Goldberg* v. *Commissioner*, 223 F. 2d 709 ..... 9
*Gotfredson* v. *Commissioner*, 217 F. 2d 673, certiorari denied, 350 U.S. 846 ..... 8
*Harry Slatkin Builders* v. *Commissioner*, 235 F. 2d 189, certiorari denied, 352 U.S. 928 ..... 8
*Helvering* v. *Kehoe*, 309 U.S. 277 ..... 9
*Helvering* v. *Nat. Grocery Co.*, 304 U.S. 282 ..... 9
*Higgins* v. *Smith*, 308 U.S. 473 ..... 10
*Holloway* v. *Commissioner*, decided December 12, 1951, affirmed *per curiam*, 203 F. 2d 566 ..... 16, 19, 20, 21, 24
*Holsey* v. *Commissioner*, 28 T.C. 962 ..... 19
*Hudson* v. *Commissioner*, 99 F. 2d 630, certiorari denied, 306 U.S. 644 ..... 19, 22
*John Kelley Co.* v. *Commissioner*, 326 U.S. 521 ..... 13
*Jones* v. *Griffin*, 216 F. 2d 685 ..... 19
*Keefe* v. *Cote*, 213 F. 2d 651 ..... 19
*Lengsfield* v. *Commissioner*, 241 F. 2d 508 ..... 22
*Lowenthal* v. *Commissioner*, 169 F. 2d 694 ..... 19, 22
*Monday* v. *Commissioner*, decided February 20, 1958 ..... 8, 9
*Northrup* v. *United States*, 240 F. 2d 304 ..... 16
*Old Colony Trust Co.* v. *Commissioner*, 279 U.S. 716 ..... 21
*Paramount-Richards Th.* v. *Commissioner*, 153 F. 2d 602 ..... 22
*Payne* v. *Commissioner*, 22 T.C. 526 ..... 15
*Raybestos-Manhattan Co.* v. *United States*, 296 U.S. 60 ..... 21

Page

*Regensburg* v. *Commissioner*, 144 F. 2d 41, certiorari denied, 323 U.S. 783 ..... 22
*Rheinstrom* v. *Connor*, 125 F. 2d 790, certiorari denied, 317 U.S. 654, rehearing denied, 317 U.S. 708 ..... 16
*Schmitt* v. *Commissioner*, 208 F. 2d 819 ..... 22
*Stockton Harbor Indus. Co.* v. *Commissioner*, 216 F. 2d 638, certiorari denied, 349 U.S. 904 ..... 9
*Tucker* v. *Commissioner*, 226 F. 2d 177 ..... 19
*United States* v. *Gypsum Co.*, 333 U.S. 364, rehearing denied, 333 U.S. 869 ..... 8
*Vesper Co.* v. *Commissioner*, 131 F. 2d 200 ..... 16
*Wall* v. *United States*, 164 F. 2d 462 ..... 19, 21, 22, 23
*Weyl-Zuckerman & Co.* v. *Commissioner*, 232 F. 2d 214 ... 9
*Wilson* v. *Commissioner*, 219 F. 2d 126 ..... 13
*Winnick* v. *Commissioner*, 223 F. 2d 266 ..... 8
*Woodworth* v. *Commissioner*, 218 F. 2d 719 ..... 16, 19, 21
*Zenz* v. *Quinlivan*, 213 F. 2d 914 ..... 16

STATUTES:

Internal Revenue Code of 1939:
Sec. 115 (26 U.S.C. 1952 ed., Sec. 115) ..... 6, 15, 21
Sec. 275 (26 U.S.C. 1952 ed., Sec. 275) ..... 23
Internal Revenue Code of 1954, Sec. 7482 (26 U.S.C. 1952 ed., Supp. II, Sec. 7482) ..... 8

MISCELLANEOUS:

Federal Rules of Civil Procedure, Rule 52(a) ..... 8
Treasury Regulations 111, Sec. 29.115-9 ..... 16

IN THE

# United States Court of Appeals For the Sixth Circuit

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Nos. 13,374 and 13,375

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MONROE ZIPP and HELEN ZIPP, *Petitioners*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

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BERNARD ZIPP and JEAN B. ZIPP, *Petitioners*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

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**On Petitions for Review of the Decisions of the Tax Court of the United States**

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## BRIEF FOR THE RESPONDENT

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### COUNTER-STATEMENT OF FACTS

Since taxpayers' statement of facts is incomplete and is in some respects at variance with the facts as found by the Tax Court, we deem it advisable to submit the following summary counter-statement:

These petitions for review of decisions of the Tax Court involve determinations of deficiencies in incom

tax for the taxable year 1950 against taxpayers Monroe and Bernard Zipp[1] in the amount of $20,926.88 each. (R. 1a, 4a).[2] These determinations were alternative to and inconsistent with a determination of deficiency in the amount of $35,837.61 asserted against Louis Zipp, father of the taxpayers, arising out of the same transaction. (R. 107a-108a.) The three cases were consolidated for trial before the Tax Court. Resolving the issues there presented, the Tax Court held (1) that Louis Zipp did not make a gift of 46 shares of stock in 1947 to his sons; (2) that he sold 48 shares of stock in 1950, and the profit realized was taxable as capital gain, as he contended, rather than as ordinary income, as contended by the Commissioner; and (3) that, in substance and effect, the corporation's funds were used for the sons' benefit to purchase the 48 shares from Louis as a consequence of which they received constructive dividends of $93,782.50, one-half of which amount was taxable to each as a dividend. (R. 118a-119a.) Taxpayers herein having petitioned for a review of the Tax Court's decisions, the Commissioner filed a protective petition for review of the decision in the case of Louis Zipp. Venue in that case lies in the United States Court of Appeals for the Fifth Circuit.

The evidence presented consisted of stipulated facts (R. 11a-13a), exhibits, and oral testimony on the basis of which the Tax Court made findings of fact (R. 108a-120a) which may be summarized as follows:

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[1] Taxpayers' wives are involved only because of the filing of joint returns.

[2] Record references are to the appendix to petitioners' brief, printed under separate cover.

Paramount Steel & Supply Company (hereinafter referred to as Paramount) is an Ohio corporation which was organized by Louis Zipp on August 27, 1936, and has at all times been engaged in the business of purchasing and reselling scrap iron. The business is highly competitive and its success was dependent upon buying skills, market fluctuations, and good relations with those concerns with which there were dealings. From the time of its organization until May 29, 1950, Louis Zipp was the general manager and dominating personality in the affairs of the corporation. (R. 109a, 110a.)

Paramount's authorized stock was 100 shares of no par value common stock when it was organized, capital in the amount of $500 was paid in and 50 shares of stock were issued which were declared to have a value of $10 per share. From 1936 to 1950, no further capital was paid into the corporation. The stock has at all times been owned and controlled by members of the Louis Zipp family. Between January 15, 1946, and May 29, 1950, Louis owned 48 and his sons Monroe and Bernard owned one each of the outstanding shares. During that period, Monroe was president of the corporation and was employed as office manager; Bernard was secretary-treasurer and was employed as sales manager; and Louis served as vice president. (R. 109a-111a.)

In 1947, at a time when he contemplated a third marriage, Louis Zipp, acting on the advice of his attorney, one Harry Elder, placed 46 shares of his stock, represented by two certificates for 23 shares each, in the names of his sons so that they could not be reached by Louis' wife, if marital difficulties arose, or in the event of his death, or in the event he became involved

in any financial deals. Under the plan devised the sons endorsed the certificates representing 23 shares each in blank and gave them to the father's attorney who kept them. At the time of the transaction (May 24, 1957), Louis told his sons that the stock was being held in trust, that he was the owner of the 46 shares, that during his lifetime he was to remain in control of the corporation, and that upon his death the 46 shares would go to them. He did not execute any written instrument to evidence a gift, either in trust or outright. However, his attorney advised him to file a federal gift tax return to make the transfer "look legal", and, accordingly, he filed such a return on or about April 17, 1948, and paid the gift tax reported thereon. Subsequently, when the Commissioner determined a deficiency in gift tax, Louis asked taxpayers Monroe and Bernard to pay the deficiency because the stock was to become theirs upon his death; they complied with the request. (R. 112a-113a.)

In 1948, Louis' business activities were curtailed because of ill health, and disputes arose between him and his sons over the operation of the business. As a result of the disputes, Louis and the corporation entered into an agreement on May 29, 1950, under the terms of which he agreed to sell two shares of his stock in Paramount to the corporation, to resign as director and general manager of the corporation, not to compete or interfere with the corporation's business, and to relinquish all rights and claims to further salaries and bonus compensation for 1950 and thereafter. In accordance with the terms of the agreement, Louis received from the corporation a total amount of $93,782.50, as follows: Cash, $75,000; cancellation of an indebtedness to the corporation, $16,682.50; and a

Cadillac automobile, $2,100. At the time of the closing of the transaction, Louis, at the insistence of the attorney for Luria Brothers, hereinafter referred to, executed a memorandum in which he acknowledged that he had no interest, right, title or claim to the 46 shares of stock represented by two certificates for 23 shares each outstanding in the names of the taxpayers but endorsed in blank. (R. 113a-117a.)

Since taxpayers did not have sufficient funds with which to purchase the business of Paramount, they arranged to borrow $75,000 from Luria Brothers, a firm with which Paramount did business. Under a written agreement dated May 29, 1950, between Luria Brothers and Paramount, Luria loaned $75,000 for which Paramount gave its note which provided for payments of $1,500 per month commencing July 1, 1950, and continuing until paid. The note was secured by mortgages on the real estate and personal property owned by the corporation. In addition, Luria Brothers was given an option to purchase all the scrap metal handled by Paramount. (R. 114a-115a.)

A special meeting of Paramount's stockholders was held on May 29, 1950, and resolutions adopted authorizing its president and secretary to borrow money for the purpose of buying Louis' stock, to negotiate with Louis for the purchase of his stock, and to do all things necessary to accomplish the stated purposes. At a subsequent meeting on the same date, Paramount's stockholders ratified the agreements with Luria Brothers and Louis Zipp, and accepted the resignation of the latter as vice president, general manager, and director of Paramount. (R. 117a.)

After May 29, 1950, taxpayers, Monroe and Bernard Zipp, owned all the 50 shares of stock of Paramount

whose funds were used to purchase the shares outstanding. The earned surplus of Paramount on May 29, 1950, amounted to $93,790.90, and such surplus represented earnings of the corporation since its organization in 1936. The entire loan of $75,000 was repaid to Luria Brothers before Paramount's business was terminated on October 1, 1953. (R. 117a, 119a.)

In computing the deficiency of the income tax liability of Louis Zipp, the Commissioner determined that he received $93,782.50 under the agreement of May 29, 1950, of which all but $20 (which was treated as a return of capital) was taxable as a dividend under Section 115(a) or (g) of the 1939 Code, and that the capital gains provisions of Section 117 did not apply.[3] The Tax Court held that the agreement of May 29, 1950, accomplished a sale by Louis of his 48 shares of stock and that his profit was taxable as capital gain. (R. 118a-119a, 127a-129a.)

In their respective returns for 1950, taxpayers did not report any income from the transaction of May 29, 1950. In determining deficiencies, the Commissioner increased the income of each by $46,891.25, one-half of $93,782.50, and by way of explanation stated that each had acquired 23 shares of Paramount stock from Louis Zipp in 1947; that the amount of $93,782.50 was withdrawn from Paramount during the year 1950 by Louis in payment for the 46 shares, and that since each taxpayer held 23 shares, 50% of $93,782.50 or $46,891.25 was taxable to each as a dividend. The Tax Court held that while Louis did not make com-

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[3] In his 1950 return Louis Zipp reported the disposition of 50 shares of Paramount stock as a $75,000 sale of a capital asset. At the trial he admitted that the total consideration received amounted to $93,782.50. (R. 119a.)

pleted *bona fide* gifts of 23 shares of stock to each of the taxpayers in May, 1947, the 1950 transaction, nonetheless, resulted in the constructive receipt of dividends by them since, as sole stockholders, they in effect, caused Paramount's cash to be distributed for their benefit, i.e., the purchase of Louis' stock. (R. 119a-120a, 124a, 128a.)

The Tax Court also found that each taxpayer omitted from gross income, as stated in his 1950 return, an amount properly includible therein which was in excess of 25% of the amount of gross income stated in the return. (R. 120a.)

## ARGUMENT

### I

**WHETHER THE PAYMENT OF THE SUM OF $93,782.70 BY A CORPORATION TO ITS (RETIRING) PRINCIPAL STOCKHOLDER IN EXCHANGE FOR ALL HIS STOCK WAS PAID ON BEHALF OF THE TAXPAYERS (THE NEW SOLE STOCKHOLDERS) AND THEREFORE RESULTED IN THE CONSTRUCTIVE RECEIPT OF DIVIDENDS BY THEM.**

**THE TAX COURT ANSWERED THE QUESTION "YES"; THE COMMISSIONER CONTENDS THAT IT WAS PROPERLY ANSWERED "YES".**

It is the position of the Commissioner that the payment of $93,782.50 (consisting of cash in the amount of $75,000, an automobile valued at $2,100, and a cancellation of Louis Zipp's indebtedness to Paramount) by Paramount to Louis Zipp was paid on behalf of taxpayers and is taxable to them as a dividend under Section 115 of the Internal Revenue Code of 1939. The validity of this proposition depends partly on whether or not Louis Zipp made a valid gift of 46 shares of stock in Paramount to taxpayers, his sons, prior to the time of the payment, and partly on the nature of the transaction between Louis and Paramount.

**A. There Was No Valid Gift**

The Tax Court, after considering the entire record, found and held (R. 118a, 121a-124a) that Louis Zipp did not make a completed *bona fide* gift of 23 shares of Paramount stock to each of his sons on May 24, 1947; that he did not give up dominion and control of the 46 shares, but rather continued to be the owner thereof until May 29, 1950; and that the names of his sons appeared on the two certificates during that intervening period merely as his nominees. In so finding, it pointed out (R. 123a) that the evidence did not establish that Louis Zipp intended to make completed gifts *in praesenti* to taxpayers of this stock on May 24, 1947, and that there was no deed of gift or actual delivery thereof to his sons. Rather, as it stated, the entire record establishes that Louis Zipp intended to retain complete ownership and control over the 46 shares of stock during his lifetime.

We submit, contrary to the contention of the taxpayer, that this finding is solely one of fact and as such is subject to the "clearly erroneous" rule. Section 7482(a), Internal Revenue Code of 1954; Rule 52(a), Federal Rules of Civil Procedure. *United States* v. *Gypsum Co.*, 333 U.S. 364, rehearing denied, 333 U.S. 869. Decisions of the Third and Fifth Circuits relied upon by taxpayers for the proposition that ultimate findings are subject to appellate review free of the restrictions of the "clearly erroneous" rule, do not reflect the views of this Court in such matters. See and cf. for example *Gotfredson* v. *Commissioner*, 217 F. 2d 673 (C.A. 6th), certiorari denied, 350 U.S. 846; *Harry Slatkin Builders* v. *Commissioner*, 235 F. 2d 189 (C.A. 6th), certiorari denied, 352 U.S. 928; *Winnick* v. *Commissioner*, 223 F. 2d 266 (C.A. 6th); *Mon-*

*day* v. *Commissioner* (C.A. 6th), decided February 20, 1958 (58-1 U.S.T.C., par. 9323); *Curtis Co.* v. *Commissioner*, 232 F. 2d 167 (C.A. 3d); *Goldberg* v. *Commissioner*, 223 F. 2d 709 (C.A. 5th). On the other hand, as appears from the citation of its cases in the above-mentioned decisions by this Court, the views of the Ninth Circuit are in harmony with those of this Court with respect to reviewing questions of fact. See for example *Stockton Harbor Indus. Co.* v. *Commissioner*, 216 F. 2d 638 (C.A. 9th), certiorari denied, 349 U.S. 904, and *Weyl-Zuckerman & Co.* v. *Commissioner*, 232 F. 2d 214 (C.A. 9th). In the latter case, the court likened the making of a finding of fact by the Tax Court to a finding of a court or jury that proven conduct of a personal injury defendant has added up to negligence. It also expressed the opinion (p. 216) that so-called inferences drawn from other facts are still findings of fact within the meaning of Rule 52(a) of the Federal Rules of Civil Procedure. And in the *Stockton* case it was stated (p. 640) that

> this court and other courts have held that it is not our function to retry questions of fact determined by the trial court upon conflicting evidence where different inferences may reasonably be drawn from them.

In the instant case, the Tax Court, whose function it was to weigh and consider the evidence before it, draw inferences therefrom, and judge the credibility of witnesses, properly exercised these functions.[4] Its ultimate finding and conclusion is supported by substantial evidence and should accordingly stand.

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[4] *Helvering* v. *Kehoe*, 309 U.S. 277, 279; *Helvering* v. *Nat. Grocery Co.*, 304 U.S. 282, 294; *Elmhurst Cemetery Co.* v. *Commissioner*, 300 U.S. 37, 40.

In considering the arrangements entered into with respect to these 46 shares of stock, it must be remembered, as the Tax Court pointed out (R. 123a) that Paramount was a family owned and controlled corporation, which was closely held, and consequently these arrangements should be closely scrutinised and governed by substance rather than form. *Commissioner* v. *Court Holding Co.*, 324 U.S. 331; *Boehm* v. *Commissioner*, 326 U.S. 287; *Higgins* v. *Smith*, 308 U.S. 473.

The facts of record show that the nominal transfer of 46 shares of his Paramount stock to taxpayers was prompted by Louis Zipp's contemplated third marriage and was part of a plan to avoid jeopardising the business of Paramount in the event he became involved in "marital trouble or any financial deals". (R. 16a, 112a.) Pursuant to that plan, and on the advice of Elder, his attorney, Louis caused three new certificates to be issued on May 24, 1947, in exchange for his one certificate for 46 shares. Two certificates for 23 shares each were issued, one in the name of Monroe Zipp and one in the name of Bernard Zipp. A third certificate for two shares was issued in Louis' name. (R. 112a.) At a meeting held in the attorney's office on that date, taxpayers endorsed in blank the certificates issued in their names. Thereafter, they remained in the possession of Elder until May 29, 1950, when taxpayers first saw them again. (R. 58a, 74a-75a, 112a.)

Louis testified (R. 17a, 26a) that at the time of this transaction it was his understanding with his sons that these shares would belong to them at the time of his death, and that during his lifetime he was the owner and would remain in control of the business. He also stated (R. 17a): "I was in no position to give away a business that I had built up in thirty, forty years.

I wasn't that wealthy at all". In support of their contention that a gift had been made, the taxpayers rely principally on statements allegedly made by attorney Elder to that effect (R. 55a, 57a, 59a) and the fact that they paid a deficiency assessment on the gift tax (R. 57a). In this latter respect, Louis testified (R. 17a) that he told the boys to pay the deficiency because "eventually the stock was going to be theirs".

The Tax Court, as the body whose function it was to weigh the evidence, draw inferences therefrom, and judge the credibility of witnesses, accepted the testimony of Louis. (R. 112a-113a.) As it pointed out, the testimony of the sons was limited to their self-serving conclusion, and there was no independent proof that each, at any time, exercised dominion and control over the shares of stock placed in their names. Neither did they offer any credible evidence to explain why they endorsed the certificates in blank, gave them to Elder, and allowed them to remain in his possession, if they regarded the 46 shares as belonging to them. The alleged explanation (R. 59a) was that Elder informed them that it was to protect them "by getting the stocks so that you will own the company", and to protect your father so that he will have recourse "if you don't live up to your agreement with him" concerning salary. Louis Zipp, however, denied that any agreement concerning salary existed at the time of the transaction. (R. 98a.) On the other hand, as the Tax Court also pointed out (R. 122a), testimony (R. 54) that after the death of his second wife (Freda) in 1947, Louis Zipp's step-daughter instituted litigation in which she claimed that one-half of the estate left by Freda was legally hers, served to corroborate Louis' motive for placing the 46 shares in the names of his sons.

Moreover, the Tax Court discredited the fact that, on Elder's advice, gift tax returns were filed reporting gifts of the stock, and also the testimony by Goldsmith, an attorney representing Paramount at the transaction of May 29, 1950, that, on that occasion, Elder had stated that the 46 shares belonged to the sons. In the opinion of the Tax Court, such fact and the alleged statement by Elder were merely consistent with the general plan of putting the stock beyond the reach of any one making a claim against Louis. (R. 123a.) Similarly, the Tax Court was unable to agree that the memorandum of May 29, 1950 (Ex. J, R. 107a) in which Louis declared that he had no interest in the 46 shares of stock was evidence of a prior gift in 1947. As it observed, under all the circumstances, the memorandum constituted a formal release, or quit claim, executed at the request of the attorney for Luria Brothers in order to protect that company for its loan of $75,000 to Paramount. (R. 124a.)

We submit, therefore, that, as held by the Tax Court, Louis Zipp did not make gifts of the 46 shares of stock to his sons in May, 1947, and that he was the owner thereof at the time he entered into the agreement with Paramount on May 29, 1950.

**B. Paramount Paid Louis Zipp $93,782.50 for His 48 Shares of Stock, and the Miscellaneous Covenants Were Merely Incidental to the Disposition of the Stock**

The Tax Court concluded (R. 125a, 127a) from an analysis of the entire record that Louis intended to surrender his entire legal and equitable interest in Paramount for a total consideration of $93,782.50, and that Paramount paid him for that interest, thus effecting a sale by Louis of his 48 shares of stock. Whether or not a corporate distribution constitutes payment for

property purchased, or something else, also presents a question of fact to be determined in each case. *John Kelley Co.* v. *Commissioner*, 326 U.S. 521; *Bogardus* v. *Commissioner*, 302 U.S. 34; *Wilson* v. *Commissioner*, 219 F. 2d 126 (C.A. 5th). In this respect, the facts here are not in dispute, only the inferences to be drawn therefrom.

Exercising its prerogative, the Tax Court, having in mind that Paramount was a closely held family controlled corporation, concluded, in effect, that since the main purpose of the agreement was to provide for the consideration Louis was to receive, the method by which it was carried out was incidental inasmuch as Louis and his sons were the only parties directly concerned in this phase of the transaction. Thus, although the agreement as drafted referred to the transfer of two, rather than Louis' entire 48 shares of stock, the Tax Court was of the opinion that the agreement was so drafted merely to reflect the record ownership of the stock and that this was sufficient under the circumstances inasmuch as previous arrangements for transferring the 46 shares to the names of the sons had been carried out, and at the time the agreement was executed other arrangements were made whereby Paramount, in order to secure Luria Brothers for the loan of $75,000 obtained from it, executed mortgages on all its assets. Furthermore, as the Tax Court also observed (R. 125a), the sales price of $93,782.50 approximated the book value ($94,290.90) of the entire stock of Paramount, on the basis of which the outstanding stock of 50 shares had a book value of $1,885.81 per share, and unless the total sum paid by Paramount was paid for something in addition to Louis' equity in the corporation, it must have been paid for the 48 shares.

To hold otherwise would lead to an absurd result, which the Tax Court was unwilling to accept, that Paramount paid $93,782.50 for two shares of stock having a book value of $3,711.62.

Neither is there any merit to the contention advanced below (R. 125a-126a) that the greater part of the consideration was paid in consideration of Louis' covenants not to enter into any competing business in Ohio for a period of ten years, or otherwise to interfere with Paramount's business, and the relinquishment of all rights and claims to further salary and extra compensation for the year 1950 and thereafter. The Tax Court found (R. 126a) that several facts of record militated against the soundness of this contention. Thus, Louis had suffered a stroke in 1948 and as a consequence was advised by his doctor to curtail his business activity. (R. 17a.) At that time, he had remarried and was living in Miami. From then until the time of the agreement in question he visited Cleveland only once a year, and his visits were of short duration. (R. 17a, 36a.) His health was not good in 1950, he was not working then, and in fact had passed up an opportunity to go into business in Miami because of his health. Nor did he ever threaten to enter into any competing business. (R. 21a-22a.)

Furthermore, the Tax Court was unable to find from the record that there were any negotiations on or before May 29, 1950, concerning the payment of any amount as consideration for the covenants not to compete or interfere with Paramount's business. As it stated (R. 126a) "they were not bargained for, nor evaluated". Rather, as the record demonstrates, and the Tax Court observed, they were inserted in the agreement to give assurances to Luria Brothers, which

had become a creditor of the corporation, concerning the future success of the business, as well as to satisfy the customary concern of the lawyers that the agreement with Louis was adequate and formally correct. (R. 78a-82a, 89a-90a.)

Finally, as the Tax Court also concluded (R. 126a-127a), the record is devoid of any evidence that any part of the total consideration paid by Paramount represented the commuted value of future salary payments to Louis. The rates of compensation for the services of Louis and his sons were fixed at the beginning of each year by corporate action, and there was no agreement in existence on May 29, 1950, providing that Louis was to receive a salary or bonus for any period after 1950. (R. 22a, 26a, 98a.)

Under these circumstances, we submit that the Tax Court correctly concluded (R. 127a) that the entire consideration of $93,782.50 was paid by Paramount for the purchase of Louis' 48 shares of stock, and that the miscellaneous covenants set forth in the agreement were merely incidental to the sale of that stock. See *Payne* v. *Commissioner,* 22 T.C. 526.

**C. The Transaction Resulted in the Constructive Receipt of Dividends by Taxpayers in 1950**

Section 115(a) of the Internal Revenue Code of 1939 (Appendix A, *infra*) defines the term "dividend" as any distribution made by a corporation to its shareholders, whether in money or other property out of earnings or profits. Section 115(g) (Appendix A, *infra*) further provides that if a corporation cancels or redeems its stock "at such time and in such manner" as to make the distribution and cancellation or redemption "essentially equivalent" to the distribution of a taxable dividend, the amount so distributed in redemp-

tion or cancellation of the stock, to the extent that it represents a distribution of earnings and profits accumulated after February 28, 1913, shall be treated as a taxable dividend. Section 29.115-9 of Treasury Regulations 111 (Appendix A, *infra*) provides that whether a distribution in connection with a cancellation or redemption of stock is essentially equivalent to a taxable dividend "depends upon the circumstances of each case". The question then, is one of fact and the determination of the trial court with respect thereto will not be distributed if supported by substantial evidence. *Woodworth* v. *Commissioner,* 218 F. 2d 719 (C.A. 6th); *Holloway* v. *Commissioner,* decided December 12, 1951 (1951 P-H Memorandum Decisions, par. 51,359), affirmed *per curiam,* 203 F. 2d 566 (C.A. 6th); *Zenz* v. *Quinlivan,* 213 F. 2d 914 (C.A. 6th); *Rheinstrom* v. *Conner,* 125 F. 2d 790 (C.A. 6th), certiorari denied, 317 U.S. 654, rehearing denied, 317 U.S. 708; *Fox* v. *Harrison,* 145 F. 2d 521 (C.A. 7th); cf. *Northrup* v. *United States,* 240 F. 2d 304 (C.A. 2d).

In resolving this factual question, the courts have generally held that it is the substance or net effect of the transaction which is determinative. *Woodworth* v. *Commissioner, supra; Flanagan* v. *Helvering,* 116 F. 2d 937, 939-940 (C.A.D.C.); *Ferro* v. *Commissioner,* 242 F. 2d 838 (C.A. 3d); *Commissioner* v. *Sullivan,* 210 F. 2d 607 (C.A. 5th); *Vesper Co.* v. *Commissioner,* 131 F. 2d 200, 203 (C.A. 8th); *Earle* v. *Woodlaw,* 245 F. 2d 119 (C.A. 9th).

In the instant case, the Tax Court held (R. 127a-128a) that it was abundantly clear from the record as a whole that the purpose of the transactions which took place on May 29, 1950, was to enable taxpayers to purchase all of Louis' interest in Paramount, and

that, in effect they thereby caused Paramount's accumulated earnings[5] to be distributed for their benefit, i.e., to purchase all of Louis' stock. The evidence of record supports this determination. Thus, on May 28, 1950, the taxpayers decided to purchase Louis' interest in the business. Being without funds of their own, and since the corporation itself did not have enough cash on hand, the taxpayers made arrangements with Luria Brothers for a loan of $75,000. (R. 64a-68a, 114a). On the following day, May 29, 1950, formal agreements were drafted. As discussed above, the Tax Court concluded that under the agreement (Ex. 6F, R. 101a-103a) between Louis Zipp and Paramount, Paramount paid Louis $93,782.50 for his 48 shares of Paramount stock (R. 127a). By the terms of another agreement (Ex. 10, Appendix B, *infra*) between Paramount and Luria Brothers, Luria loaned Paramount $75,000 for which Paramount executed a note in that amount providing for payments of $1,500 per month. The note was secured by mortgages on the real and personal property of Paramount. As an inducement for Luria to make the loan, the agreement provided that Luria was to have an option to purchase all of Paramount's scrap, as it saw fit. (R. 71a-72a, 11a.) Both agreements were signed on behalf of Paramount by the taxpayers. (R. 71a, 103a.) At the time of the meeting when these agreements were signed, Louis Zipp received a cash payment of $75,000 and the loan in that amount obtained from Luria Brothers was subsequently repaid by Paramount. (R. 70a, 72a.)

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[5] On May 29, 1950, Paramount's surplus amounted to $93,790.90 and such surplus represented earnings of the corporation since its organization in 1936. (R. 117a.)

On the day, May 29, 1950, these agreements were executed, a special meeting of Paramount stockholders was held. The minutes (Ex. 7-G, Appendix B, *infra*) of that meeting recite that the purpose thereof was to consider the purchase of shares of Paramount stock held by Louis. A resolution was adopted authorizing the president and secretary to negotiate the purchase, to negotiate for a loan to effect the purchase, and to enter into agreements and do all things necessary and incidental to accomplishing those ends. After these matters were accomplished, Paramount's shareholders ratified in all respects the agreements with Louis Zipp and Luria Brothers, and accepted the resignation of Louis as vice president, general manager, and director of Paramount. (R. 117a.) The Tax Court found (R. 119a) that thereafter taxpayers owned all the 50 outstanding shares of Paramount stock, and that these shares had been purchased with funds of Paramount. As the Tax Court observed (R 127a-128a) taxpayers were able to proceed as they did because Paramount was a family controlled corporation, and came under their complete control. It concluded (R. 128a) that "The arrangements had the same effect as though the stockholders had withdrawn funds from Paramount for their own use and benefit", and since Paramount had accumulated an earned surplus of $93,790.90, the payment of $93,782.50 by Paramount "constituted taxable dividends constructively received by Monroe and Bernard in 1950, in the amount of $46,891.25 each".

The net effect of the above-described transactions is that the earned surplus of Paramount has been paid out to confer benefit on its stockholders, taxpayers herein. The law is now well established that the use of corporate income for the personal benefit of stock-

holders, as distinguished from benefit to the corporate enterprise, constitutes taxable dividends to the stockholders so benefited. *Woodworth* v. *Commissioner, supra; Hudson* v. *Commissioner,* 99 F. 2d 630 (C.A. 6th), certiorari denied, 306 U.S. 644; *Holloway* v. *Commissioner, supra; Wall* v. *United States,* 164 F. 2d 462 (C.A. 4th); *Ferro* v. *Commissioner, supra; Lowenthal* v. *Commissioner,* 169 F. 2d 694 (C.A. 7th); *Holsey* v. *Commissioner,* 28 T.C. 962, pending on appeal in the Third Circuit; cf. *Commissioner* v. *Sullivan supra; Jones* v. *Griffin,* 216 F. 2d 685 (C.A. 10th); *Keefe* v. *Cote,* 213 F. 2d 651 (C.A. 1st); and *Tucker* v. *Commissioner,* 226 F. 2d 177 (C.A. 8th), in all of which the corporate distribution was found to have served a corporate business purpose. Clearly no corporate purpose was served by the transactions here involved, and it is not so contended by the taxpayers.

The facts and circumstances of the instant case are quite similar to those in the *Woodworth* and *Holloway* cases, *supra,* and, we submit, they support the decision in the instant case. In the *Woodworth* case, the principal stockholder of a corporation sold her stock to a syndicate pursuant to a written agreement which provided that delivery of the stock would be made to the syndicate members or their nominees upon payment of the balance of the purchase price. Thereafter a series of transactions occurred whereby a new board of directors, consisting principally of syndicate members, ratified the purchase of the stock by *the corporation* and the use of corporate securities and assets to pay for the stock; the assets were delivered to a bank which issued its check payable to the corporation; the check was endorsed by the corporation and delivered to the retiring stockholder; other cashier's checks

representing the balance of the corporation's quick assets and the proceeds of two loans to the corporation were also delivered to the stockholder in full payment for the stock purchased; and the syndicate members executed and delivered their personal notes to the corporation in the total amount of the purchase price. Thereafter, the corporation issued certificates of stock in the names of the syndicate members but retained them as security for payment of the notes. Subsequently, the syndicate members surrendered 75% of the number of shares standing in their names and received credit on their notes. The Tax Court found that the retiring stockholder had sold her stock to the syndicate members, not to the corporation; that the members had, in effect, borrowed corporate funds with which to purchase the stock; and that, following the cancellation of their notes, the relative position of the stockholders to the corporation remained the same. It concluded that the cancellation of the notes was essentially equivalent to a taxable dividend to the syndicate members. This Court affirmed the Tax Court's decision.

Similarly, in the *Holloway* case, the taxpayer-stockholder accepted an offer made by other stockholders to purchase their 158 shares of stock and directed that the certificates, endorsed in blank, be delivered to a bank in exchange for the agreed purchase price. Taxpayer then drew a corporate check in payment for the stock. He then held a stockholder's meeting, at which he was the only stockholder present. The minutes of that meeting recited that he had acted on behalf of the corporation in purchasing the shares of stock and showed ratification of his action. Thereafter, taxpayer caused the shares to be cancelled and retired.

The Tax Court stated that the facts and circumstances of record left no doubt in its mind that the use by taxpayer of corporate funds with which to purchase the shares, and their subsequent surrender, was essentially equivalent to a distribution of a taxable dividend within Section 115(g), *supra*. This Court affirmed the Tax Court's decision.

While, strictly speaking, there was no redemption or cancellation of Paramount's stock herein, nevertheless the same result obtained for the corporate earnings were permanently distributed for the benefit of the taxpayers. Thus, in *Wall* v. *United States*, 164 F. 2d 462 (C.A. 4th), the facts in which were similar to those in the *Woodworth* and *Holloway* cases, the Fourth Circuit in sustaining a deficiency under Section 115(g) reasoned that a corporation's payment of a stockholder's indebtedness to a third party pursuant to an agreement between them is income to the stockholder-taxpayer;[6] that if a corporation, instead of paying a dividend to a stockholder, pays a debt for him out of surplus, it is the same for tax purposes as if the corporation had paid the dividend to the stockholder, and the stockholder had then utilized it to pay his debt. Under the findings of the Tax Court, this is in effect what took place here.

Even if not deemed a distribution under Section 115(g), *supra*, the payment made on behalf of the taxpayers directly responds to the definition of a taxable dividend contained in Section 115(a) of the Code, *supra*. This is so even though the formalities of a dividend declaration have not been observed. See

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[6] *Douglas* v. *Willcuts*, 296 U.S. 1; *Old Colony Trust Co.* v. *Commissioner*, 279 U.S. 716; *Raybestos-Manhattan Co.* v. *United States*, 296 U.S. 60.

*Hudson* v. *Commissioner*, 99 F. 2d 630 (C.A. 6th), certiorari denied, 306 U.S. 644; *Chattanooga Sav. Bank* v. *Brewer*, 17 F. 2d 79 (C.A. 6th), certiorari denied, 274 U.S. 751; *Cohen* v. *Commissioner*, 77 F. 2d 184 (C.A. 6th), certiorari denied, 296 U.S. 610; *Paramount-Richards Th.* v. *Commissioner*, 153 F. 2d 602 (C.A. 5th); *Lengefeld* v. *Commissioner*, 241 F. 2d 508 (C.A. 5th); *Regensburg* v. *Commissioner*, 144 F. 2d 41 (C.A. 2d), certiorari denied, 323 U.S. 783; *Christopher* v. *Burnet*, 55 F. 2d 527 (C.A.D.C.). In this respect, it is to be remembered that the payment out of corporate earnings was made with the knowledge and acquiescence of Louis Zipp who testified that he read and understood the 1950 agreement with Paramount. (R. 27a).

The cases of *Fox* v. *Harrison*, 145 F. 2d 521 (C.A. 7th), and *Schmitt* v. *Commissioner*, 208 F. 2d 819 (C.A. 3d), so strongly relied on by taxpayers are plainly distinguishable on their facts. In the *Fox* case, the court held that in reality the stock was purchased by the corporation, and that the taxpayer merely acted as agent of the corporation. In fact the court which decided the *Fox* case distinguished it in *Lowenthal* v. *Commissioner*, 169 F. 2d 694, 700 (C.A. 7th). See also *Wall* v. *United States*, *supra*, p. 466. The *Schmitt* case merely held that no taxable event took place when treasury stock of a corporation was distributed to the taxpayers in proportion to their holdings in the corporation. The Tax Court, is noted, rejected (R. 128a) taxpayers' argument, based on the *Schmitt* case, as being without merit in the light of all the facts and circumstances herein.

Taxpayers' further argument (Br. 35-42) that they realized no financial or economic benefit by reason of

the 1950 transactions is also without merit. Assuming that to be true, however, as the court stated in *Wall* v. *United States, supra,* p. 465, it is entirely beside the point at issue for we are not concerned with the broad question of whether the business in which taxpayers are engaged will ultimately result to their advantage and show a profit on the investment, but with the narrower question of whether in legal effect taxpayers received a dividend from the corporation through the payment out of its funds for the purchase of the stock in question. In any event, it is clear that taxpayers acquired exactly what they bargained for and that after the 1950 transactions were consummated they owned all the outstanding shares of Paramount and had complete control of its affairs.

## II

**WHETHER THE ASSESSMENT AND COLLECTION OF THE DEFICIENCY DUE FROM EACH TAXPAYER FOR THE TAXABLE YEAR 1950 IS BARRED BY THE STATUTE OF LIMITATIONS.**

**THE TAX COURT ANSWERED THE QUESTION "NO"; THE COMMISSIONER CONTENDS THAT IT WAS PROPERLY ANSWERED "NO".**

Section 275(c) of the Internal Revenue Code of 1939 (Appendix A, *infra*) provides that a tax may be assessed at any time within five years after the return is filed if the taxpayer omits from gross income an amount properly includible therein, which is in excess of 25% of the amount of gross income stated in the return.

The 1950 returns of taxpayers were filed on March 15, 1951, and each reported gross income in the amount of $15,300. (Exs. 2c and 3c.) A notice of deficiency was mailed to each of the taxpayers on November 23, 1955, a date within the five-year period. (R. 6a, 10a.)

The Commissioner determined that each taxpayer had omitted dividend income in the amount of $46,891.25 from his 1950 return and asserted deficiencies accordingly. (R. 8a-9a, 119a-120a.) It is apparent that if this Court sustains that determination, as did the Tax Court, taxpayers each failed to report in excess of 25% of their 1950 gross income, and hence the assessment and collection is not barred by the statute of limitations. *Holloway* v. *Commissioner, supra.*

Respectfully submitted,

CHARLES K. RICE,
*Assistant Attorney General.*

LEE A. JACKSON,
ROBERT N. ANDERSON,
GEORGE F. LYNCH,
*Attorneys,*
*Department of Justice,*
*Washington 25, D. C.*

MARCH, 1958.

## APPENDIX A

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

(26 U.S.C. 1952 ed., Sec. 22.)

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this chapter * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b) *Source of Distributions.*—For the purposes of this chapter every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. * * *

* * * * *

(g) *Redemption of Stock.*—If a corporation cancels or redeems its stock (whether or not such stock

was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

* * * * * *

(j) *Valuation of Dividend.*—If the whole or any part of a dividend is paid to a shareholder in any medium other than money the property received other than money shall be included in gross income at its fair market value at the time as of which it becomes income to the shareholder.

* * * * * *

(26 U.S.C. 1952 ed., Sec. 115.)

SEC. 275. PERIOD OF LIMITATION UPON ASSESSMENT AND COLLECTION.

(a) *General Rule.*—The amount of income taxes imposed by this chapter shall be assessed within three years after the return was filed, and no proceeding in court without assessment for the collection of such taxes shall be begun after the expiration of such period.

* * * * * *

(c) *Omission from Gross Income.*—If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 per centum of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 5 years after the return was filed.

* * * * * *

(26 U.S.C. 1952 ed., Sec. 275.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

SEC. 29.115-9. *Distribution in redemption or cancellation of stock taxable as a dividend.*—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

The question whether a distribution in connection with a cancellation or redemption of stock is essentially equivalent to the distribution of a taxable dividend depends upon the circumstances of each case. A cancellation or redemption by a corporation of a portion of its stock pro rata among all the shareholders will generally be considered as effecting a distribution essentially equivalent to a dividend distribution to the extent of the earnings and profits accumulated after February 28, 1913. On the other hand, a cancellation or redemption by a corporation of all of the stock of a particular shareholder, so that the shareholder ceases to be interested in the affairs of the corporation, does not effect a distribution of a taxable dividend. A bona fide distribution in complete cancellation or redemption of all of the stock of a corporation, or one of a series of bona fide distributions in complete cancellation or redemption of all of the stock of a corporation, is not essentially equivalent to the distribution of a taxable dividend. If a distribution is made pursuant to a corporate resolution reciting that the distribution is made in liquidation of the corporation, and the corporation is com-

pletely liquidated and dissolved within one year after the distribution, the distribution will not be considered essentially equivalent to the distribution of a taxable dividend; in all other cases the facts and circumstances should be reported to the Commissioner for his determination whether the distribution, or any part thereof, is essentially equivalent to the distribution of a taxable dividend.

**APPENDIX B**

**Joint Exhibit 7-G**

MINUTES OF A SPECIAL MEETING OF THE SHAREHOLDERS OF THE PARAMOUNT STEEL AND SUPPLY COMPANY, HELD AT THE OFFICE OF THE COMPANY, 6800 Union Avenue, CLEVELAND, OHIO, ON THE 29th day of MAY, 1950 at 1:00 P. M.

**Waiver of Notice**

We, the undersigned, being the holders of 48 shares of stock of The Paramount Steel and Supply Company, do hereby waive notice of a special meeting of The Paramount Steel and Supply Company to be held on May 29, 1950 at 1:00 P. M. at 6800 Union Avenue, Cleveland, Ohio, for the purpose of considering the purchase of shares of stock held by Louis H. Zipp and to do any and all things incidental thereto.

MONROE ZIPP
Monroe Zipp

/s/ BERNARD ZIPP
Bernard Zipp

The president, Monroe Zipp, announced that the purpose of the meeting was to discuss an offer by Louis H. Zipp, holder of two shares of stock of The Paramount Steel and Supply Company, to sell such certificates of stock and transfer, assign, deliver and convey all his interest in the corporation, to the corporation. After a full discussion was had, Bernard Zipp thereupon presented the following resolution:

WHEREAS, Louis H. Zipp is the holder and owner of two shares of common stock, and is the holder of the office of vice president and a member of the Board of Directors of the corporation, and, pursuant to contract, is the general manager of said corporation; and

WHEREAS, various differences have arisen between the parties and the said Louis H. Zipp has offered to sell said certificates of stock and resign as officer, director and general manager of said corporation; and

WHEREAS, it is for the best interests of this corporation that said corporation purchase said shares of stock; and

WHEREAS, it is necessary to negotiate and effect a loan for the purpose of purchasing said shares of stock.

NOW, THEREFORE, BE IT RESOLVED that the president and the secretary be and they hereby are authorized to enter into negotiations with the said Louis H. Zipp for the purchase of his shares of stock and for the purpose of obtaining his resignation and withdrawal as and from the office of vice president, director, and as general manager; further, that the president and the secretary be, and they hereby are authorized and empowered to enter into negotiations for the purpose of obtaining a loan to effectuate the aforesaid purpose; further, that they be and hereby are authorized and directed to enter into agreements with the said Louis H. Zipp and with a loaning firm for the purpose of obtaining such capital and that they may do any and all things necessary and incidental to accomplishing the purposes hereof."

A full discussion was thereupon had, a vote was taken, and said resolution was unanimously carried.

Bernard Zipp thereupon moved that the meeting be temporarily adjourned until 4:30 P. M. to await the report of the officers on such negotiations.

The meeting was temporarily adjourned.

The meeting was resumed at 4:30 P. M. all of the shareholders being then present. The president announced that an agreement had been entered into with the said Louis H. Zipp for the purpose of purchasing his shares of stock and

obtaining his resignation as officer, director and general manager and further that a loan had been negotiated and effected through the Luria Brothers. The president thereupon presented an agreement dated May 29, 1950 by and between said Louis H. Zipp and the corporation for the purchase of said shares.

The president further announced that a loan of $75,000 had been negotiated and effected through the Luria Brothers and Company, Inc., a Pennsylvania corporation, in consideration of an agreement entered into by and between Luria Bros. and Company, Inc. and The Paramount Steel and Supply Company for the purchase and sale of all available scrap and in consideration of the execution and delivery of a promissory note in the face amount of $75,000, and being non-interest bearing, and secured by a mortgage on all the property of the corporation, real, personal and mixed, and payable at the rate of $1,500 per month until fully paid.

Bernard Zipp thereupon presented the following resolution:

"WHEREAS, The Paramount Steel and Supply Company and Louis H. Zipp have entered into an agreement dated May 29, 1950 to which reference is herein made, by the terms of which the said Louis H. Zipp promised and agreed to sell, assign and transfer to the corporation a certificate of stock for two shares of common stock of the corporation, to resign as director, officer, and general manager and further agreed not to engage in the scrap iron or steel business, either directly or indirectly for a period of ten years from date in the State of Ohio, relinquishing any rights or claims to funds, salaries or compensation due or which may be due him, and warranting said stock to be free and clear of any claims of any nature, and in consideration of which the corporation promised and agreed to pay to the said Louis H. Zipp the sum of $75,000, to convey to him a 1948 Cadillac automobile, and to

forgive all indebtedness of the said Louis H. Zipp, including, without limiting the generality of the foregoing, salary paid to him for the year 1950; and

WHEREAS, it is for the best interests of this corporation that said agreement be entered into, ratified and approved.

NOW, THEREFORE, BE IT RESOLVED that the corporation does hereby ratify, confirm, adopt and approve the agreement entered into with Louis H. Zipp and dated May 29, 1950, to which reference is hereby made."

A full discussion was thereupon had, a vote was taken, and said resolution was unanimously carried.

Bernard Zipp thereupon presented the following resolution:

"WHEREAS, it was for the best interests of the corporation to purchase the stock of one Louis H. Zipp and to enter into an agreement with him therefore; and

WHEREAS, it was necessary to obtain funds to accomplish said purchase of stock; and

WHEREAS, a loan was negotiated from Luria Bros. and Company, Inc. in the amount of $75,000 to effect such purchase of stock; and

WHEREAS, on the 29th day of May, 1950 Luria Bros. and Company, Inc. and the corporation entered into a certain agreement dated May 29, 1950 which reads as follows:

AGREEMENT

THIS AGREEMENT, made and concluded at Cleveland, Ohio, this 29th day of May, 1950 by and between LURIA BROTHERS & COMPANY, INC., a Pennsylvania corporation, licensed to do business in the State of Ohio, hereinafter

called "Luria", and PARAMOUNT STEEL & SUPPLY COMPANY, an Ohio corporation, hereinafter called "Paramount", both of Cleveland, Ohio,

WITNESSETH:

WHEREAS Paramount is engaged in the business of purchasing and reselling steel scrap, and desires to sell all of its available scrap to Luria, and to have an assured outlet for the same; and

WHEREAS, Luria is engaged in the business of purchasing and reselling steel scrap, and desires to purchase all of Paramount's available scrap, and to have an assured source of supply of the same; and

WHEREAS, on May 29, 1950 Luria lent to Paramount the sum of Seventy-Five Thousand Dollars ($75,000) cash,

NOW, THEREFORE, for and in consideration of the said loan by Luria to Paramount, and in further consideration of the mutual promises herein contained, Paramount agrees to sell and deliver, and Luria agrees to accept and pay for, steel scrap, in the quantities, at the prices and terms, upon and under the terms and conditions hereinafter set forth, and during the term of this agreement; as follows, to wit:

1. Paramount agrees to sell to Luria, and Luria agrees to purchase from Paramount, all steel scrap now held or hereafter obtained by Paramount for resale. Luria, however, shall not be required to purchase unreasonable quantities.

2. Paramount further agrees that it will not sell any scrap now held by it, or hereafter acquired, to any other person, firm or corporation, unless the same has been rejected by Luria.

3. The price to be paid for said steel scrap by Luria shall be the then prevailing market price for said steel scrap at the time and place of each delivery to Luria, f.o.b. Cleveland, Ohio. In the event that there is a dispute at

any time between the parties hereto as to the then prevailing market price, said prevailing market price shall be determined by Luria's then quoted prices to others for purchasing the same.

4. Luria agrees to pay Paramount in cash for all scrap received and accepted by it from Paramount, provided, however, that Luria shall deduct from Paramount's invoices for the same $1.00 for each ton of scrap, which $1.00 per ton shall be applied by Luria as payment toward said loan of Seventy-Five Thousand Dollars ($75,000), as evidenced by Paramount's promissory note of even date herewith. In any event, Paramount shall pay Luria in the aggregate at least Fifteen Hundred Dollars ($1,500) each month on said loan.

5. The term of this agreement shall commence on May 29, 1950, and shall continue without right of revocation or termination in either party until said loan has been paid in full or September 30, 1954 which ever event occurs later. Upon the expiration of said abovementioned term, the terms of this agreement will remain in force thereafter until either party hereto gives a thirty (30) day written notice to the other of its intention to terminate this agreement; it being further provided, however, that, in the event either party shall be adjudged a bankrupt or make an assignment for creditors, or if a receiver shall be appointed for its business, or if it shall attempt to assign its interest in this agreement, then, in any such event, the other party may, at its option, cancel and terminate this agreement forthwith.

IN WITNESS WHEREOF, the parties hereto have hereunto set their corporate hands as of the day and year first above written.

Signed in the presence of:

LURIA BROTHERS & COMPANY, INC.

By

Cleveland Manager

As to Luria

PARAMOUNT STEEL & SUPPLY COMPANY

By

President

And

Secretary

As to Paramount

WHEREAS, The Paramount Steel and Supply Company, by its president and secretary, have executed and delivered to Luria Bros. and Company, Inc., a promissory note dated May 29, 1950 in the face amount of $75,000 providing for payment at the rate of $1,500 per month commencing July 1, 1950 and continuing thereafter monthly on the first day of each month in each year until paid, said note being secured by a mortgage deed on the real estate known as 6800 Union Avenue and a chattel mortgage on all the motor vehicles owned by The Paramount Steel and Supply Company and further secured by a chattel mortgage on all personal property and chattels now located at 6800 Union Avenue, Cleveland, Ohio;

NOW, THEREFORE, BE IT RESOLVED that the agreement dated May 29, 1950 by and between Luria Bros. and Company, Inc., a Pennsylvania corporation, and The Paramount Steel and Supply Company, as hereinbefore set forth, be and the same is hereby ratified,

confirmed and adopted and the act of the officers in entering into such agreement is hereby approved.

BE IT FURTHER RESOLVED that the acts of the president and secretary, in executing and delivering said promissory note, secured by the mortgages on the real estate, automobiles and other personal property of the corporation be and the same is hereby ratified, confirmed and adopted by the corporation."

After a full discussion, said resolution was voted upon and unanimously carried.

The president thereupon presented the resignation of Louis H. Zipp from the office of vice president, director and general manager of The Paramount Steel and Supply Company, and after a discussion, said resignation was unanimously accepted.

The president thereupon announced that the next item of business was the election of a member to the Board of Directors to complete the unexpired term of Louis H. Zipp as director." Bernard Zipp thereupon nominated Esther Jean Zipp as director for such unexpired term.

There being no further nominations for such office, the president thereupon declared the said Esther Jean Zipp unanimously elected to the office of director for the balance of the term of the said Louis H. Zipp.

There being no further business before said meeting, same was duly adjourned.

MONROE ZIPP
President.

ATTEST:
/s/ BERNARD ZIPP
Bernard Zipp
Secretary.

**Petitioners' Exhibit 10**

## AGREEMENT

THIS AGREEMENT, made and concluded at Cleveland, Ohio, this 29th day of May, 1950, by and between LURIA BROTHERS & COMPANY, INC., a Pennsylvania corporation, licensed to do business in the State of Ohio, hereinafter called "Luria", and PARAMOUNT STEEL & SUPPLY COMPANY, an Ohio corporation, hereinafter called "Paramount", both of Cleveland, Ohio,

WITNESSETH:

WHEREAS Paramount is engaged in the business of purchasing and reselling steel scrap, and desires to sell all of its available scrap to Luria, and to have an assured outlet for the same; and

WHEREAS, Luria is engaged in the business of purchasing and reselling steel scrap, and desires to purchase all of Paramount's available scrap, and to have an assured source of supply of the same; and

WHEREAS, on May 29, 1950 Luria lent to Paramount the sum of Seventy-Five Thousand Dollars ($75,000) cash,

NOW, THEREFORE, for and in consideration of the said loan by Luria to Paramount, and in further consideration of the mutual promises herein contained, Paramount agrees to sell and deliver, and Luria agrees to accept and pay for, steel scrap, in the quantities, at the prices and terms, upon and under the terms and conditions hereinafter set forth, and during the term of this agreement, as follows, to wit:

1. Paramount agrees to sell to Luria, and Luria agrees to purchase from Paramount, all steel scrap now held or hereafter obtained by Paramount for resale. Luria, however, shall not be required to purchase unreasonable quantities.

*Petitioners' Exhibit 10*

2. Paramount further agrees that it will not sell any scrap now held by it, or hereafter acquired, to any other person, firm or corporation, unless the same has been rejected by Luria.

3. The price to be paid for said steel scrap by Luria shall be the then prevailing market price for said steel scrap at the time and place of each delivery to Luria, f. o. b. Cleveland, Ohio. In the event that there is a dispute at any time between the parties hereto as to the then prevailing market price, said prevailing market price shall be determined by Luria's then quoted prices to others for purchasing the same.

4. Luria agrees to pay Paramount in cash for all scrap received and accepted by it from Paramount, provided, however, that Luria shall deduct from Paramount's invoices for the same $1.00 for each ton of scrap, which $1.00 per ton shall be applied by Luria as payment toward said loan of Seventy-Five Thousand Dollars ($75,000), as evidenced by Paramount's promissory note of even date herewith. In any event, Paramount shall pay Luria in the aggregate at least Fifteen Hundred Dollars ($1,500) each month on said loan.

5. The term of this agreement shall commence on May 29, 1950, and shall continue without right of revocation or termination in either party until said loan has been paid in full or September 30, 1954 whichever event occurs later. Upon the expiration of said abovementioned term, the terms of this agreement will remain in force thereafter until either party hereto gives a thirty (30) day written notice to the other of its intention to terminate this agreement; it being further provided, however, that, in the event either party shall be adjudged a bankrupt or make an assignment for creditors, or if a receiver shall be appointed for its business, or if it shall attempt to assign its interest in this agreement, then, in any such

event, the other party may, at its option, cancel and terminate this agreement forthwith.

IN WITNESS WHEREOF, the parties hereto have hereunto set their corporate hands as of the day and year first above written.

Signed in the presence of:

/s/ EARL I. TURNER
As to Luria

/s/ M. I. GOLDSMITH
As to Paramount

LURIA BROTHERS & COMPANY, INC.
By /s/ JACK LEVAND
*Cleveland Manager*

PARAMOUNT STEEL & SUPPLY COMPANY
By /s/ MONROE ZIPP
*President*
And /s/ BERNARD ZIPP
*Secretary*

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# INDEX


| | Page |
|---|---|
| Opinions below | 1 |
| Jurisdiction | 1 |
| Question presented | 2 |
| Statutes and Regulations involved | 2 |
| Statement | 2 |
| Argument | 6 |
| Conclusion | 9 |
| Appendix A | 11 |
| Appendix B | 14 |


## CITATIONS

CASES:


| | |
|---|---|
| *Bogardus* v. *Commissioner*, 302 U.S. 34 | 6 |
| *Comstock* v. *Group of Investors*, 335 U.S. 221 | 7 |
| *Ferro* v. *Commissioner*, 242 F. 2d 838 | 8 |
| *Garden State Developers Inc.* v. *Commissioner*, 30 T.C. 135 | 7 |
| *Holloway* v. *Commissioner*, decided December 12, 1951 (T.C., affirmed *per curiam*, 203 F. 2d 566 | 6-7 |
| *Holsey* v. *Commissioner*, 258 F. 2d 865 | 7, 8 |
| *Kelley Co., John* v. *Commissioner*, 326 U.S. 521 | 6 |
| *Lowenthal* v. *Commissioner*, 169 F. 2d 694 | 8 |
| *Paramount-Richards Theatres* v. *Commissioner*, 153 F. 2d 602 | 8 |
| *Tucker* v. *Commissioner*, 226 F. 2d 177 | 8, 9 |
| *Wall* v. *United States*, 164 F. 2d 462 | 7 |
| *Wilson* v. *Commissioner*, 219 F. 2d 126 | 6 |
| *Woodworth* v. *Commissioner*, 218 F. 2d 719 | 6, 7-8 |


STATUTES:


| | |
|---|---|
| Internal Revenue Code of 1939: | |
| Sec. 22(a) (26 U.S.C. 1952 ed., Sec. 22(a)) | 11 |
| Sec. 115(a) (26 U.S.C. 1952 ed., Sec. 115(a)) | 11 |
| Sec. 115(b) (26 U.S.C. 1952 ed., Sec. 115(b)) | 11 |
| Sec. 115(g) (26 U.S.C. 1952 ed., Sec. 115(g)) | 12 |
| Sec. 115(j) (26 U.S.C. 1952 ed., Sec. 115 (j)) | 12 |


MISCELLANEOUS:


| | |
|---|---|
| Rev. Rul. 58-614, 1958-51 Int. Rev. Bull. 49 | 7, 8, 14 |
| Treasury Regulations 111, Sec. 29.115-9 | 12 |

# In the Supreme Court of the United States

OCTOBER TERM, 1958

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No. 663

MONROE ZIPP, ET AL., *Petitioners*

v.

COMMISSIONER OF INTERNAL REVENUE

---

**On Petition for a Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit**

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## BRIEF FOR THE RESPONDENT IN OPPOSITION

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### OPINIONS BELOW

The opinion of the Tax Court (R. 107a-129a)[1] is reported at 28 T.C. 314. The opinion of the Court of Appeals (Pet. 16-19) is reported at 259 F. 2d 119.

### JURISDICTION

The judgment of the Court of Appeals was entered on May 21, 1958, and an order denying taxpayers' peti-

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[1] Record references are to the appendix to taxpayers' brief below printed under separate cover.

tion for rehearing was entered on October 27, 1958. (Pet. 19.) The petition for a writ of certiorari was filed on January 24, 1959. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

## QUESTION PRESENTED

Whether the purchase by a corporation of all the stock of its principal stockholder was made on behalf of the taxpayers (the new sole stockholders) and therefore resulted in the constructive receipt of dividends by them under Section 115 of the Internal Revenue Code of 1939.

## STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of the Internal Revenue Code of 1939, 26 U.S.C. 1952 ed., Secs. 22 and 115, and of Treasury Regulations 111 are printed in Appendix A, *infra*, pp. 11-13.

## STATEMENT

The findings of the Tax Court (R. 108a-120a) are summarized in the opinion of the Court of Appeals (Pet. 16-18) and are substantially as follows:

The Paramount Steel and Supply Company had a total of fifty shares of capital stock outstanding, all of which, except two qualifying shares held by his two sons, Bernard and Monroe, petitioners herein, were owned by Louis Zipp. On May 24, 1947, Louis caused three new certificates to be issued, two for 23 shares each in the names of Bernard and Monroe respectively, and one for two shares in his own name. The certificates issued in the names of the sons were endorsed in blank by them and delivered to the custody of their father's attorney, who was also attorney for Para-

mount. This transaction was occasioned by the fact that the father contemplated remarriage. Accordingly, he discussed with his attorney the possible effect of such step upon his financial interest in Paramount and the possibility of future marital difficulties which might jeopardize his interest in the company as well as interfere with the operation of its business. On the advice of his attorney, all except two shares of the Paramount stock owned by Louis Zipp were put in the names of his two sons "so that they could not be reached by Louis' wife, if marital difficulties arose, or in the event of Louis' death, or in the event Louis became involved in any financial deals". (R. 109a-110a, 112a-113a; Pet. 16-17.)

Some time thereafter, Louis and his sons, all of whom were officers of Paramount, became involved in controversies concerning the operation of the business of Paramount as a result of which it was orally agreed that the sons would purchase the business. Since the sons did not have sufficient funds with which to purchase the business, they arranged to borrow $75,000 from Luria Brothers, a firm with which Paramount did business. Under a written agreement, dated May 29, 1950, between Luria Brothers and Paramount, Luria loaned the latter $75,000 for which Paramount gave its note which provided for repayments of $1,500 per month, commencing July 1, 1950, and continuing until paid. The note was secured by mortgages on the real and personal property owned by the corporation. (R. 111a, 113a-115a; Pet. 17.)

On the same date, May 29, 1950, Louis and Paramount executed an agreement under the terms of which he agreed to sell his two remaining shares of stock

in Paramount to the corporation, to resign as director and general manager, to refrain from competing or interfering with the corporation's business, and to relinquish all rights and claims to further salaries and bonus compensation for 1950 and thereafter. In accordance with the terms of the agreement, Louis received from Paramount a total consideration of $93,782.50, comprised of $75,000 in cash; cancellation of an indebtedness to the corporation of $16,682.50; and an automobile valued at $2,100. The agreement also recited that the earned surplus of Paramount as of May 29, 1950, amounted to $93,790.90. Upon the closing of the transaction, Louis, at the insistence of the attorney for Luria Brothers, executed a memorandum in which he acknowledged that he had no interest, right, title or claim to the above referred to 46 shares of stock represented by two certificates for 23 shares each outstanding in the names of the taxpayers, his sons, but endorsed by them in blank. (R. 114a-117a; Pet. 17.)

A special meeting of Paramount's stockholders was held on May 29, 1950, and resolutions were adopted authorizing its president and secretary (the petitioners) to borrow money for the purpose of buying Louis' stock, to negotiate for the purchase of his stock, and to do all things necessary to accomplish those purposes. At a subsequent meeting on the same date, Paramount's stockholders ratified the agreements with Luria Brothers and Louis Zipp. (R. 117a.)

The Tax Court further found as a fact that Louis did not make completed bona fide gifts of 23 shares of stock to each of his sons on May 24, 1947, but that on the contrary he remained the owner thereof and

was such at the time he entered into the agreement with Paramount on May 29, 1950; that the total consideration of $93,782.50 received by Louis from Paramount was in exchange for all his 48 shares of stock in the company, of which two shares standing in his name were endorsed in blank by Louis and surrendered; and that after May 29, 1950, the taxpayers owned all 50 shares of Paramount stock, the funds of which company had been used to purchase 48 shares of that stock in equal shares for each brother. (R. 117a-119a; Pet. 17.)

The taxpayers did not report any income from the transaction of May 29, 1950. In determining deficiencies, the Commissioner increased the income of each son by $46,891.25, one-half of $93,782.50, on the theory that such amount had been withdrawn from Paramount by Louis in payment for 46 shares of the company's capital stock which were acquired by the sons from their father as a result of the transaction. The Commissioner concluded that the sum of $46,891.25 was taxable to each son as a dividend.[2] The Tax Court upheld these determinations upon the ground that the father, Louis, had not made completed bona fide gifts of 23 shares of stock to each of his sons in May, 1947; that his sons were mere nominees whose names were used to suit his convenience; and that Louis had re-

[2] These determinations were alternative to and inconsistent with a determination of a deficiency asserted against Louis Zipp arising out of the same transaction. (R. 119a.) When the taxpayers herein petitioned for review, the Commissioner filed a protective petition for review of the decision as to Louis. Venue in that case lies in the United States Court of Appeals for the Fifth Circuit and proceedings therein have been postponed pending final determination of this case.

mained the owner of the shares and was such at the time he entered into the agreement with Paramount on May 29, 1950. Accordingly, the Tax Court concluded that Paramount had paid Louis $93,782.50 for all 48 shares of his stock and that Louis had sold those shares, it being abundantly clear that the transactions of May 29, 1950, were to enable the sons to purchase all the father's interest in Paramount; that since Paramount was a family corporation it was possible for them to proceed as they had; that the sons had not made loans from Paramount, but had caused its cash to be distributed for their benefit, namely, to enable them to purchase all their father's stock; and that, finally, inasmuch as Paramount had accumulated earned surplus in the amount of $93,790.90, the payment of $93,782.50 by Paramount constituted taxable dividends constructively received in equal parts by the two sons. (R. 119a-120a, 124a, 128a; Pet. 17-19.)

The Court of Appeals affirmed the decisions of the Tax Court on the basis of the findings of fact and opinion of the Tax Court. (Pet. 19.)

## ARGUMENT

Whether or not a corporate distribution constitutes payment for property purchased on behalf of a stockholder and whether or not a distribution in connection with a cancellation or redemption of stock is essentially equivalent to a taxable dividend constitute questions of fact. *John Kelley Co.* v. *Commissioner,* 326 U.S. 521; *Bogardus* v. *Commissioner,* 302 U.S. 34; *Wilson* v. *Commissioner,* 219 F. 2d 126 (C.A. 5th); *Woodworth* v. *Commissioner,* 218 F. 2d 719 (C. A. 6th); *Holloway* v. *Commissioner,* decided December 12, 1951 (1951 P-H T.C. Memorandum Decisions, par. 51,359), affirmed

*per curiam*, 203 F. 2d 566 (C.A. 6th). Thus, this case presents a question which is entirely factual and does not call for review by this Court. Both courts below have concurred in the findings that, as a result of the transaction of May 29, 1950, the taxpayers constructively received taxable dividends. A settled rule of this Court makes concurrent findings of two courts below final in the absence of exceptional circumstances. *Comstock* v. *Group of Investors*, 335 U.S. 211, 214. The findings in this case are fully supported by the evidence, and the taxpayers have failed to show a need for further review.

1. Under the decided cases and the administrative rulings the crucial factor in determining if a purchase of stock constitutes a constructive dividend to the remaining stockholders is whether the stock is, in reality, purchased by the corporation or by the remaining stockholders. If the corporation makes the purchase the remaining stockholders do not receive a constructive dividend merely because their percentage interests in the corporation are increased. *Holsey* v. *Commissioner*, 258 F. 2d 865 (C.A. 3rd). If, on the other hand, the stock is in reality purchased by a remaining shareholder and paid for by the corporation, then, regardless of the form of the transaction, the payment is considered a dividend to the shareholder who made the purchase. *Wall* v. *United States*, 164 F. 2d 462 (C.A. 4th); Rev. Rul. 58-614, 1958-51 Int. Rev. Bull. 49, *infra*, pp. 14-15; cf. *Garden State Developers, Inc.* v. *Commissioner*, 30 T.C. 135. This is merely an application of the accepted tax principle that a purchase made with corporate funds for the benefit of a stockholder constitutes a constructive dividend to him. *Wall*,

*worth* v. *Commissioner, supra*; *Lowenthal* v. *Commissioner,* 169 F. 2d 694 (C.A. 7th); *Ferro* v. *Commissioner,* 242 F. 2d 838 (C.A. 3rd). See also *Paramount-Richards Theatres* v. *Commissioner,* 153 F. 2d 602 (C.A. 5th). Here, the Tax Court ruled that "[t]he arrangements had the same effect as though the sole stockholders had withdrawn funds from Paramount for their own use and benefit" (R. 128a) and this ruling is dispositive of petitioners' contentions.

2. There is no conflict of decision with either *Holsey* v. *Commissioner,* 258 F. 2d 865 (C.A. 3rd), or *Tucker* v. *Commissioner,* 226 F. 2d 177 (C.A. 8th), as asserted by petitioners (Pet. 8-10). In *Holsey,* under the particular facts of that case, the Third Circuit found that the stock was, in fact and in reality, purchased, not by the remaining stockholder, but by the corporation. Following that decision, the Service announced (Rev. Rul. 58-614, 1958-51 Int. Rev. Bull. 49, *infra,* p. 14) that it would follow *Holsey* in cases involving similar facts and circumstances, citing and distinguishing this case as being one, unlike *Holsey,* where the stock was in reality purchased by the remaining shareholders.

The *Tucker* case, *supra,* involved payments by a corporation of a percentage of its profits to a former stockholder as part consideration for the sale and transfer by him of all of his stock to an existing stockholder-manager who thereby became the owner of a controlling interest in the corporation, thus satisfying a requirement that as manager of a corporation holding an automobile-dealer franchise he have a controlling interest therein. Reversing the Tax Court which had held that the payments made constituted dividends to the stockholder who acquired the stock, the Eighth

Circuit held that that transaction satisfied a proper corporate purpose, namely, to preserve a valuable corporate asset (the franchise) and to enable the company to continue as a going concern, and that, in such circumstances, the payments should not be treated as income constructively received. As the court pointed out (226 F. 2d at 179), it was not considering a case where one in control of a corporation had, under pretense of corporate action, siphoned off its profits for purely personal purposes. In view, then, of the facts and circumstances under which the transaction in this case was effected, it is clear that here no corporate purpose was involved, but rather that corporate earnings were used solely to enable the taxpayers to accomplish their personal purpose of purchasing their father's interest in the business. Thus, the *Tucker* case, *supra*, does not involve any conflict with the instant decision.

## CONCLUSION

We submit that the question presented is not one calling for review by this Court. Of necessity cases arising under Sec. 115(g) will present a variety of close factual questions. The general standard applied by the Service in dealing with such questions is clearly stated in its ruling, *infra*, p. 14. That standard is in accord with the statute, and its application to particular factual situations presents no problem warranting review.

For the reasons set forth above the petition for a writ of certiorari should be denied.

Respectfully submitted,

J. LEE RANKIN,
*Solictor General.*

CHARLES K. RICE,
*Assistant Attorney General.*

ROBERT N. ANDERSON,
GEORGE F. LYNCH,
*Attorneys.*

FEBRUARY 1959

## APPENDIX A

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

(26 U.S.C. 1952 ed., Sec. 22.)

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this chapter * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b) *Source of Distributions.*—For the purposes of this chapter every distribution is made out of earnings or profits to the extent thereof, and

from the most recently accumulated earnings or profits. * * *

* * * * *

(g) *Redemption of Stock.*—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

* * * * *

(j) *Valuation of Dividend.*—If the whole or any part of a dividend is paid to a shareholder in any medium other than money the property received other than money shall be included in gross income at its fair market value at the time as of which it becomes income to the shareholder.

* * * * *

(26 U.S.C. 1952 ed., Sec. 115.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

SEC. 29.115-9. *Distribution in redemption or cancellation of stock taxable as a dividend.*—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock,

to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

The question whether a distribution in connection with a cancellation or redemption of stock is essentially equivalent to the distribution of a taxable dividend depends upon the circumstances of each case. A cancellation or redemption by a corporation of a portion of its stock pro rata among all the shareholders will generally be considered as effecting a distribution essentially equivalent to a dividend distribution to the extent of the earnings and profits accumulated after February 28, 1913. On the other hand, a cancellation or redemption by a corporation of all of the stock of a particular shareholder, so that the shareholder ceases to be interested in the affairs of the corporation, does not effect a distribution of a taxable dividend. A bona fide distribution in complete cancellation or redemption of all of the stock of a corporation, or one of a series of bona fide distributions in complete cancellation or redemption of all of the stock of a corporation, is not essentially equivalent to the distribution of a taxable dividend. If a distribution is made pursuant to a corporate resolution reciting that the distribution is made in liquidation of the corporation, and the corporation is completely liquidated and dissolved within one year after the distribution, the distribution will not be considered essentially equivalent to the distribution of a taxable dividend; in all other cases the facts and circumstances should be reported to the Commissioner for his determination whether the distribution, or any part thereof, is essentially equivalent to the distribution of a taxable dividend.

## APPENDIX B

**Revenue Ruling 58-614, 1958-51 Int. Rev. Bull. 49**

SECTION 115(g).—DISTRIBUTIONS BY CORPORATIONS: REDEMPTION OF STOCK

REGULATIONS 118, SECTION 39.115(g)-1:

Distribution in redemption or cancellation of stock taxable as a dividend.

The Internal Revenue Service will follow the decision of the United States Court of Appeals for the Third Circuit, rendered September 3, 1958, in the case of *Joseph R. Holsey et ux* v. *Commissioner,* in cases involving similar facts and circumstances.

The decision holds that a remaining shareholder of a corporation does not receive a constructive dividend by way of enhancement in the value of his stock as a result of a purchase by the corporation of another shareholder's stock.

In the future, the Service will not treat the purchase by a corporation of one shareholder's stock as a dividend to the remaining shareholders merely because their percentage interests in the corporation are increased. On the other hand, if the stock is in reality purchased by a remaining shareholder and paid for by the corporation, then, regardless of the form of the transaction, the payment will be considered a dividend to the shareholder who made the purchase. This position is in accord with the decisions of *H. F. Wall* v. *Commissioner,* 164 Fed. (2d) 462, *Louis H. Zipp* v. *Commissioner,* affirmed by the United States Court of Appeals for the Sixth Circuit, May 21, 1958, and similar court holdings.

In these transactions, if a shareholder surrenders stock to a corporation for less than its fair market value, such surrender may be a gift or compensation

to the shareholders who remain interested in the corporation. Conversely, if a corporation pays more than fair market value for its stock, the payment may be compensation to the shareholder surrendering stock or may be a gift to him from the shareholders who remain interested in the corporation.

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# In the Supreme Court of the United States

OCTOBER TERM, 1958.

No. 663.

MONROE ZIPP, *et al.*,
*Petitioners,*

v.

COMMISSIONER OF INTERNAL REVENUE,
*Respondent.*

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT.

## REPLY BRIEF OF PETITIONERS.

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# In the Supreme Court of the United States

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MONROE ZIPP, *et al.*,

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COMMISSIONER OF INTERNAL REVENUE,

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ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT.

## REPLY BRIEF OF PETITIONERS.

### I.

Respondent, in its Brief in Opposition to Petitioners' Petition for a Writ of Certiorari, states at page 6 that:

> "Whether or not a corporate distribution constitutes payment for property purchased on behalf of a stockholder and whether or not a distribution in connection with a cancellation or redemption of stock is essentially equivalent to a taxable dividend constitute questions of fact."

In support of this statement the Respondent cites two cases decided by this Honorable Court, both of which do not support this conclusion. In *John Kelley Co. v. Commissioner* (1946) 326 U. S. 521, the issue was whether distributions by a corporation as interest on the corporation's debentures were in effect interest or dividends. This Honorable Court applied the *Dobson* rule announced in *Dobson v. Commissioner* (1943) 320 U. S. 489 and held

that the conclusion of the Tax Court should be accepted by the Court of Appeals and by this Honorable Court. *However*, in 1948, section 1141(a) of the 1939 Code (substantially section 7482 of the 1954 Code) was added by Congress expressly to repeal the rule laid down in the *Dobson* case. Pub. Law. 773, Sec. 36, 80th Cong. 2nd Sess.; Sen. Rep. No. 1559, 80th Cong. 2nd Sess. (1948). It is obvious the *Kelley* case cited by the Respondent can have no application to the case at bar.

In *Bogardus v. Commissioner* (1937) 302 U. S. 34, cited by Respondent, the issue was whether or not payments made to employees were compensation or gifts. In contradiction to Respondent's citation of this case as authority for its quoted statement, this Honorable Court said that the questions presented were:

> "'* * * a conclusion of law, or at least a determination of a mixed question of law and fact. It is to be distinguished from findings of primary, evidentiary or circumstantial facts. It is subject to judicial review and, on such review, the court may substitute its judgment for that of the Board.' *Helvering v. Tex-Penn Oil Co.*, 300 U. S. 481, 491; *Helvering v. Rankin*, 295 U. S. 123, 131. That the conclusion of the Board be regarded as a determination of a mixed question of law and fact, it has as we shall presently show, no support in the primary and evidentiary facts. The ultimate determination, therefore, should be overturned under the doctrine of *Helvering v. Rankin*, supra, as a matter of law." (p. 39.)

Sec. 1141(a) of the 1939 Code provides for review of the Tax Court decisions "in the same manner and to the same extent as decisions of the District Courts in civil actions tried without a jury." Under Rule 52(a) of the Federal Rules of Civil Procedure "findings of fact shall not be set aside unless clearly erroneous. * * *" However,

the rule that the appellate court is bound by the facts as determined by the Tax Court unless they are "clearly erroneous" is directed *only* to *evidentiary* facts. If the finding involves an *ultimate* fact rather than the evidence on which it is based, the appellate court may substitute its judgment for that of the Tax Court. See *Commissioner v. Heininger* (1943) 320 U. S. 467, 475; *Helvering v. Tex-Penn Oil Co.* (1937) 300 U. S. 481, 491; *Bogardus v. Commissioner, supra; Botany Worsted Mills v. U. S.* (1929) 278 U. S. 282, 290; *Baumgartner v. U. S.* (1944) 322 U. S. 665; *Smith v. Dunn* (CA 5th 1955) 224 F. 2d 353; *Goldberg v. Commissioner* (CA 5th 1955) 223 F. 2d 709. Insofar as a so-called "ultimate finding" is simply the result reached by processes of legal reasoning from, or the interpretation of the legal significance of, the evidentiary facts, it is "subject to review free of the restraining impact of the so-called 'clearly erroneous' rule." *Lehmann v. Acheson* (CA 3rd 1953) 206 F. 2d 592, 594; *Hypotheek Land Co. v. Commissioner* (CA 9th 1952) 200 F. 2d 390. Findings of fact that are induced by an erroneous view of the law are not binding. Nor are findings that combine both fact and law, when there is error as to the law. *Galena Oaks Corp. v. Scofield* (CA 5th 1954) 218 F. 2d 217.

The issue in the case at bar of whether Paramount Steel and Supply Co.'s distribution to Louis Zipp was essentially equivalent to taxable dividends received by Petitioners is a conclusion of law, or at least a combined finding of fact and conclusion of law. *Bogardus v. Commissioner, supra; Wilson v. U. S.* (CA 2nd 1958) 257 F. 2d 534; *Earle v. Woodlaw* (CA 9th 1957) 245 F. 2d 119, cert. den. 354 U. S. 942; *Northup v. U. S.* (CA 2nd 1957) 240 F. 2d 304; *Pacific Vegetable Oil Corp. v. Commissioner* (CA 9th 1957) 251 F. 2d 682. This Honorable Court has always had the power "to modify or to reverse" such decisions.

## II.

Petitioners admit that the statements of law made by Respondent in its brief in paragraph 1 beginning on p. 7 may be supported by the cases cited. However, the controlling fact present in all the cases cited by Respondent was that the corporation's distribution, whether for purchase of stock or otherwise, satisfied or discharged some obligation or indebtedness of the remaining stockholders. This satisfaction or discharge of the remaining stockholders' indebtedness or obligation was the benefit received which constituted a constructive dividend to them.

*In the case at bar, however, the Courts below did not find any agreement between Louis Zipp and Petitioners relating to Louis' transfer of stock, nor did the Courts below find that the Petitioners in any way obligated themselves personally to pay for any part of the stock sold by Louis Zipp. The only existing obligation to pay for the shares purchased was the obligation of the corporation, Paramount Steel and Supply Co., under its agreement with Louis Zipp executed May 29, 1950.*

A serious error in Respondent's statement of facts must be pointed out. Respondent states (Resp. 3):

> "Sometime thereafter, Louis and his sons, all of whom were officers of Paramount, became involved in controversies concerning the operation of the business of Paramount as a result of which *it was orally agreed that the sons would purchase the business.*" (Emphasis supplied.)

No such agreement was found to exist by the Tax Court. In fact the Court in its opinion (R. 127a) states as follows:

> "The record as a whole establishes that *Monroe and Bernard decided* on May 28th to purchase all of Louis' interest in the corporation, but *they were without suf-*

*ficient funds to make the purchase themselves.* * * *"
(Emphasis supplied.)

After finding that the corporation then arranged for a loan with which it proceeded to purchase Louis' stock (R. 127a), the Court further stated:

> "*In effect* they (petitioners) caused Paramount's cash to be distributed for their benefit, i.e., to purchase all of Louis' stock. * * * The arrangement had the same *effect* as though the sole stockholders had withdrawn funds from Paramount for their own use and benefit." (Emphasis supplied.)

This is certainly not a finding of an oral agreement between Monroe and Bernard on the one hand and Louis Zipp on the other, involving the purchase of Louis' stock.

Therefore, this contention of Respondent must also fall since this controlling or essential fact is lacking in the case at bar.

## III.

Respondent argues that the decisions in the case at bar are not in conflict with *Holsey v. Commissioner* (CA 3rd 1958) 258 F. 2d 865, since in *Holsey* the corporation, not the remaining stockholders, purchased the stock in question (Resp. 8-9).

Here again Respondent relies upon a fact which the Tax Court *did not find*, viz., that Petitioners and not the corporation bought Louis Zipp's stock. The essential facts of the *Holsey* case and the case at bar are the same.

Respondent further says that the instant case is not in conflict with *Tucker v. Commissioner* (CA 8th 1955) 226 F. 2d 177, since in *Tucker* the distribution by the corporation served a proper corporate purpose, while in the case at bar no such corporate purpose was served. In the first instance, whether or not a proper corporate purpose

is served by the corporation's purchase of stock is irrelevant. It is the *effect* of the transaction rather than the *purpose* which actuated it which controls. *Holsey v. Commissioner, supra; Northup v. U. S.* (CA 2nd 1957) 240 F. 2d 304.

However, if a proper corporate purpose is deemed a consideration in the instant case, it is clear that Paramount Steel and Supply Co.'s purchase of Louis Zipp's interest in the corporation did serve a proper corporate purpose, namely, to insure harmony in the management of the corporation. The Tax Court here found constant bickering and dissension between Louis Zipp and Petitioners regarding the management of the corporation culminating in threats by Louis which, if carried out, would have been harmful to Paramount's business (R. 113a-114a). See *Emeloid Co. Inc. v. Commissioner* (CA 3rd 1951) 189 F. 2d 230, 233.

## CONCLUSION.

Since this Honorable Court does have the power to review and reverse or modify the decisions of the courts below, and because the decisions here are in conflict with decisions of other circuits of the United States Court of Appeals, and for the further reasons set forth in the Petition for Writ of Certiorari, it is respectfully submitted that said petition be granted.

Respectfully submitted,

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